Italy: Staff Concluding Statement of the 2022 Article IV Mission

May 19, 2022

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

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

Washington, DC: *Following the impressive recovery from the pandemic shock, the Italian economy is now facing headwinds from the war in Ukraine and rising inflation. Despite signs of resilience, growth is expected to slow under the baseline, with risks on the downside. Compensation measures should protect the vulnerable while preserving price signals. An expenditure-based adjustment could achieve a significant but gradual improvement in the fiscal balance and public debt. Banks weathered the pandemic crisis well, but a cautious approach to capital is warranted. Sharp curtailment of energy supplies would call for comprehensive liquidity and income support measures, but the scale should reflect the more constrained room for policy. Delivering National Recovery and Resilience Plan (NRRP) investments and reforms would support productivity and potential growth and accelerate the green transition.*

The Italian economy achieved an impressive recovery from the pandemic shock, returning close to the pre-COVID level of output by late 2021. Employment has also rebounded and the labor market is tightening. This reflects the successful vaccination campaign and policies to insulate incomes and profits of households and firms, thereby avoiding significant economic scarring.

Like its EU partners, Italy is now facing formidable new economic 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 owing to its high dependence on imported energy from Russia. Government bond yields have recently risen and spreads have widened on expectations of faster monetary

policy normalization and concerns about Italy's high public debt amid slowing growth. Notwithstanding, growth shows signs of resilience so far this year. The service sector is expanding strongly, with tourism recovering toward pre-COVID levels. The construction sector is booming owing to generous investment tax credits, and manufacturing has remained in growth territory through April, although moderating since end-2021.

GDP growth is forecast to slow this year and next in the baseline where Russian energy imports are gradually phased out. Higher energy and food prices are expected to erode households' real incomes, negatively impacting consumption despite partial fiscal compensation for more expensive energy bills and large excess savings accumulated during the pandemic. Rising interest rates and the negative shock to confidence are expected to dampen private investment. Firms are projected to scale back production relative to plans due to shortages of key inputs and shrinking profit margins. The external sector contribution to growth is projected to be lower on weaker demand from EU trading partners. In all, annual growth is seen as moderating to around 2½ percent and 1¾ percent in 2022 and 2023, respectively. Year-average inflation is projected to peak this year at 5½ percent. Over the medium term, growth is forecast to stabilize at just over 1 percent on continued NRRP-related spending and some moderation of commodity prices.

Downside risks could materially affect this outlook. A more abrupt tightening of financial conditions could further reduce growth, increase the cost of funding and slow the pace of decline in public debt, and cause banks to scale back lending. Difficulties achieving NRRP investments and reforms would slow growth and productivity enhancements, and delay accompanying EU funding. On the other hand, additional fiscal stimulus could moderate the growth slowdown, but also fuel a price-wage spiral in the context of supply constraints and high commodity prices. An abrupt near-term shutoff of Russian energy imports could reduce output significantly in both 2022 and 2023 relative to the baseline even assuming that other supplies can replace half the immediate shortfall by next winter. In that context, funding costs for the sovereign and banks would likely further increase on weakening tax collections and loan quality.

Managing the energy shock

Balancing energy security, affordability and decarbonization has become more difficult in the face of sharply higher energy prices and the risk of supply shutoffs. Guided by the REPowerEU plan, the government is appropriately securing replacement supplies of energy through agreements with other countries (amounting to about half of normal gas imports from Russia by next winter), expanding LNG regasification capacity, delaying the phase out of coal power plants, accelerating the seasonal storage of gas, and speeding up approval procedures for renewable electricity capacity. While this could temporarily set back progress with decarbonization, 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. Reviewing pricing and tax arrangements for energy imports and renewables-based electricity may be appropriate to limit excessive windfall rents and their transmission to end-user prices.

Compensation measures for the energy price shock should preserve price signals while cushioning the impact on the most vulnerable. Poorer households and energy-intensive firms in the tradeable sector have been disproportionately affected by higher energy prices. Several compensation measures have focused on cutting energy taxes and fees, and while this immediately lowers prices for households and firms, energy efficiency is discouraged and benefits accrue to all customers—including those whose bills have not materially risen and those able to afford the increase. The more recent social bonus, which

provides targeted cash transfers to more vulnerable households, is therefore preferred. Some temporary tax credits have also been provided to energy-intensive firms to prevent excessive bankruptcies and large downstream supply chain impacts, which is appropriate when energy prices have temporarily overshot their long-run level and support is targeted to viable firms.

Charting a fiscal strategy

A more restrained fiscal response to the energy shock than to the pandemic is warranted. In recent years, households and firms were supported during the pandemic, the social safety net was strengthened through a universal means-tested child allowance and compensation has been provided for higher energy bills. While adhering to the budgeted deficit target for 2022, substantial additional fiscal support to the economy is also provided through the Superbonus and other tax credits, retroactive payouts on recently-agreed public administration wage contracts and large new hiring in the context of the NRRP. In the context of elevated public debt, rising financing costs and the apparent resilience of demand and output to the energy shock, additional windfall revenue from stronger cyclical conditions should therefore be saved.

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 by 1–2 percentage points below nominal GDP growth and further improving tax compliance would achieve an appropriately paced fiscal adjustment, which should commence already in 2023 in the baseline scenario and could deliver a primary surplus of 2 percent of GDP by 2030. A comprehensive review of the budget to find meaningful savings from existing spending and tax programs should underpin the spending-based strategy. Over the longer term, maintaining this spending restraint and keeping the primary surplus at 2 percent would create room for priority investments (climate, energy, education, digitalization, innovation) even after accommodating the anticipated hump in pension spending while also reducing public debt to around 135 percent of GDP by 2030, with further sustained debt reduction thereafter.

Continuing to improve policy design would reduce risks of fiscal slippage and support debt reduction. The recent strengthening of job acceptance requirements and links to training in the Citizenship Income program are a welcome step, but to avoid welfare dependence and disincentives to work, the rate of benefit withdrawal in response to earned income should be gradual while the benefit level is high relative to the cost of living in some parts of the country. 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. To avoid unintended distortions, the tax on windfall profits of energy companies should be based on the full range of items that determine their profits.

Preserving financial stability

Improved financial strength since the start of the pandemic should allow banks to weather the tighter financial conditions and spillovers from the war in Ukraine under the baseline scenario. Further reductions in nonperforming loans, recourse to the public guarantee scheme 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. However, tighter financial conditions alongside slower growth are likely to put pressure on banks' capital on average, but with considerable variation across the sector. The envisaged new loan guarantee scheme targeting energy-intensive firms would help to finance their higher expenses. However, eligibility should be selective, with enhanced credit risk assessments at origination and guarantee coverage rates lower than in pandemic schemes. No generalized liquidity support measures are currently called for. Banks should diligently apply loan classification standards and recovery procedures on their guarantee portfolios.

However, caution is advised given the elevated uncertainty and sequential nature of the current crisis. 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.

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. Robust supervisory assessments with targeted asset quality reviews should continue in order to pre-emptively identify vulnerable banks, including less significant institutions. To reduce moral hazard, using resources of the Italian banking sector's deposit guarantee scheme to prevent bank failures outside of resolution or liquidation should be avoided except where there are strong prospects for successful rehabilitation and long-term viability. Increasing digitalization, improving governance, and further consolidating the sector amid growing competition from fintechs and other banks remain priorities.

Policies for a severe scenario

In the event of a sharp growth downgrade, a comprehensive policy response would be appropriate, but should reflect the more constrained policy space. Pandemic-era policy tools would be appropriate in this scenario to limit social hardship and excessive business insolvencies. However, with public debt some 15 percentage points of GDP higher than before the pandemic and with tighter financing conditions, 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.

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 avoid a 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 tend to obscure borrowers' true repayment capacity. New guarantees could be made available and the maturity of existing guarantees lengthened. However, banks should be required to retain a larger part of the credit risk on their own balance sheets for new and lengthened guarantees, and excessive issuance should be avoided. Further extending the duration of the government support scheme for securitizing impaired loans could be considered in order to reduce the risk that any near-term increase in banks' NPLs becomes structural. Recent Italian experience suggests the merits of

temporarily allowing banks greater flexibility to restructure their non-guaranteed loans without triggering forborne thresholds.

Structural priorities

Italy has made commendable strides in reducing carbon emissions, but re-invigorating efforts is needed to support energy security and climate commitments. Considerable carbon reduction has been achieved in the energy and manufacturing sectors, which are subject to the EU Emissions Trading System, while emissions reduction in transport reflects high excises on fuels. However, progress in other sectors, in particular the residential sector, is limited and a marked acceleration is needed to meet Fit-for-55 goals. Much larger investment in renewable energy, in particular by the private sector, is key to a greener and more self-sufficient electricity sector, and which would also facilitate carbon reduction in the building and transport sectors through greater electrification. Recent measures to streamline approvals of new renewable capacity, including ex ante identification of suitable sites across the country, are showing positive results. Less volatile fossil fuel prices, supported by a gradually increasing carbon price floor, could also encourage investment. Improving the value for money of the housing Superbonus program is needed as energy efficiency improvements are poorly targeted and the subsidy rate is excessive, despite planned reductions over time.

Full and timely implementation of the NRRP is critical to lift productivity and boost potential growth. Bringing the reforms and investments to completion would reduce possible scarring from the energy crisis, support the green transition and enhance the economy's ability to adjust to relative price changes. The frontloading of reforms—notably in public administration, simplification of procedures, civil justice and competition—in the NRRP is intended to support the efficient execution of public investments scheduled for the second half of the period covered by the Plan. Hence, successfully completing ongoing reforms is crucial for improving the quality of public infrastructure and the efficiency of resource utilization.

We are grateful to the Italian authorities and our private sector counterparts for generously giving their time to the mission and for the informative discussions.