Italy: Staff Concluding Statement of the 2016 Article IV Mission

May 23, 2016

1. The economy continues to recover from a deep and protracted recession. Buoyed by exceptionally accommodative monetary policy, favorable commodity prices, supportive fiscal policy, and improved confidence on the back of the authorities' wide-ranging reform efforts, the economy grew by 0.8 percent in 2015 and continued to expand in the first quarter of 2016. At the same time, labor market conditions have been gradually improving, and nonperforming loans (NPLs) appear to be stabilizing. Still, the challenges ahead are significant. Productivity and investment growth are low; the unemployment rate remains above 11 percent, with considerably higher levels in some regions and among the youth; bank balance sheets are strained by very high NPLs and lengthy judicial processes; and public debt inched up to just under 133 percent of GDP, a level that limits the fiscal space to respond to shocks.

2. The recovery is likely to strengthen but remain modest in the coming years. Against the backdrop of structural rigidities and subdued demand, growth is projected to reach 1.1 percent this year and about 1¼ percent in 2017–18 (on planned policies). Risks are tilted to the downside, including from financial market volatility, Brexit, the refugee surge, and headwinds from the slowdown in global trade. This growth path would imply a return to pre-crisis (2007) output levels only by the mid-2020s and a widening of Italy's income gap with the faster-growing euro area average. Moreover, nominal growth may be too weak to firmly unwind financial fragilities and balance sheets could remain a source of vulnerability, as their repair would occur over a protracted period. Within an incomplete economic and monetary union, Italy would remain exposed to risks.

3. Cognizant of Italy's complex challenges, the government has been pursuing a range of important reforms. The list of reform initiatives has been impressive. Institutional, public administration, fiscal, labor market, and banking sector reforms have been aimed at addressing long-standing structural rigidities that pre-date the crisis. In particular, the government's signature labor market legislation, the Jobs Act, is being implemented; legislation has been passed on the reform of cooperative and mutual banks; the insolvency system is being revised; a framework law on public administration has been approved and some implementing decrees have been issued; a reform of the state budget is commencing; and legislation has been passed and a constitutional referendum is planned for October on electoral reforms aiming to facilitate decision making, and the transfer of competencies from regions to the center.

4. It is imperative that these efforts are expanded and completed. Taking advantage of the start of economic recovery and the current favorable low interest rate environment, the timely implementation of complementary and mutually reinforcing efforts in the financial and fiscal sectors and structural measures would help boost growth, start the rebuilding of buffers, and lower the upfront cost of reforms. It is therefore important that broad political support for comprehensive reforms is maintained in the period ahead.

Structural reforms

5. Building on the recent reform progress, further steps in three priority areas could help lift growth. As recent IMF research has shown (World Economic Outlook, April 2016), ambitious product and service market reforms have the potential to yield near- as well as long-term growth dividends. Public administration reform can lower the cost of doing business and improve the investment climate. A new wage bargaining system that helps align wages with productivity would contribute to improving competitiveness and complement the Jobs Act.

- *Product and service market reform*. Notwithstanding the requirement since 2009 for an annual competition law every year, such a law is yet to be approved. A draft law, which continues to be debated in parliament, seeks to address regulatory barriers to entry and competition in a number of sectors and services. Strengthening several provisions of the law in line with the recommendations of the competition authority, and ensuring an annual process of adopting pro-competition laws, would be critical to their effectiveness. Going forward, consideration should be given to enhancing competition in other areas, including in local public service provision, transport, legal and professional services, as well as to full implementation of existing legislation (e.g., retail sector).
- *Public administration reform*. The government took welcome legislative measures in August 2015 and January 2016, and should advance reforms aimed at improving the skill-mix in the public sector, matching positions with skills, aligning wages with productivity, simplifying functions and procedures, rationalizing procurement, and tackling privileges and employment in public enterprises, including through privatization.
- *Wage bargaining*. The Jobs Act is expected to result in significant changes to the labor market over time, reducing segmentation and duality. The focus should now turn to modernizing the wage bargaining system—by broadening the scope for firms, specifically smaller enterprises as well as many in the South, to engage in effective firm-level negotiations that strengthen the link between wages and productivity. It would also help alleviate regional disparities in labor outcomes and economic performance.

Strengthening banks' ability to support the recovery

6. Several important steps have been taken recently toward fostering the stability and viability of the banking system. Weak asset quality and low profitability are weighing on banks and are a result, inter alia, of long recovery times on collateral. To address these issues, the authorities launched much needed insolvency reforms to reduce the time to collect claims, where Italy has lagged other countries in Europe, and introduced out-of-court enforcement in commercial lending relationships to reduce significantly the time to recover secured loans. These are positive changes that will require proper implementation, including supporting infrastructure and adequate resources. Moreover, reforms of the cooperative and mutual bank frameworks have finally created the opportunity for a welcome consolidation in the coming years.

7. Further actions can support these measures. While current measures could gradually improve the legal environment for credit, their full impact is likely to be realized only over the medium term. Additional actions should aim at materially reducing the current stock of NPLs over the medium term, lowering the cost of risk, and improving operating efficiency.

- *Further improve insolvency and enforcement*. More intensive use of out-of-court debt restructuring mechanisms, alongside a triage approach for enterprises to identify viable firms and focus restructuring efforts on them, could facilitate quicker progress in reducing current NPLs, drive down processing times, and enhance recovery values. The systematization of the insolvency system underway offers an opportunity to address outstanding issues, such as integrating recent reforms into a coherent framework, with priorities including simplifying procedures and rationalizing appeals. Adoption of best practices by courts across Italy would notably enhance the effectiveness of the reforms.
- *Prudential steps to resolve NPLs*. Banks should be required to produce comprehensive NPL strategies that commit to operational targets to reduce NPL levels markedly over the medium term (via more efficient internal workout procedures, outsourcing to external servicers, and outright sales). Intensified supervisory oversight of banks' internal management of NPL resolution should include a regular NPL reporting requirement and an intensive schedule of on-site monitoring led by collections and workout experts.

- *Supervisory oversight of consolidation*. Bank consolidation is an important route toward a more efficient banking system, particularly for weaker banks. Prudential supervisors should encourage and carefully assess banks' consolidation proposals, with a focus on a detailed assessment of balance sheet health, long-term viability and strong governance, and provide clear guidance on supervisory expectations and timelines. In that regard, asset quality should be assessed systematically for those banks not already subject to the European Central Bank comprehensive assessment, with follow-up actions in line with regulatory requirements. It is important that this work commences promptly.
- *Retail investor protection*. The entry into force of new European legislation changes the way bank crises are managed and re-establishes creditor hierarchy. In this regard, the authorities should review potential anomalies surrounding bank retail debt issuances and address any issues found. Irregular selling practices to retail customers should be prevented, including through strengthening legal and regulatory safeguards, increasing the quality of the information, and the effectiveness of controls.
- *Atlante*. Recent private sector intervention to backstop bank recapitalizations has helped preserve financial stability. It provides a window of opportunity to press forward decisively on the authorities' various measures, including on the ones mentioned above, to ensure that the banking system is on a sounder footing and that such interventions do not eventually weigh on the profitability of participating banks. Bank supervisors should ensure that banks' future investments are based solely on commercial considerations.

Bolstering fiscal sustainability

8. Fiscal policy faces a difficult balancing act of reducing the high public debt and supporting growth. Following a sizable fiscal adjustment in 2012–13, when Italy reached one of the highest structural primary surpluses in the euro zone, the fiscal stance has turned more supportive of growth, including in the current year. While this supported domestic demand at a time when growth was low, it also used up the windfall gains from the falling interest bill, and the debt-to-GDP ratio has continued to edge up in recent years. The debt dynamics are expected to improve in the coming years, if nominal growth materializes as projected and the medium-term fiscal targets are achieved as planned. However, the improvement will be gradual and vulnerable to shocks, such as a rise in interest rates. Ambitious privatization would help lower debt faster.

9. Taking advantage of the low interest rate environment, fiscal policy should remain anchored to an ambitious medium-term consolidation path, supported by pro-growth policies, to secure public debt on a firmer downward path.

- Unless the authorities are successful in boosting potential growth through decisive reform implementation, the current relaxation in 2016 (in structural terms) entails the risk of a future procyclical tightening. In this regard, it provides an important opportunity and the necessary policy space to advance more decisively structural reforms, including in the fiscal area.
- Given the growth outlook, a somewhat faster structural tightening than currently envisaged would help reduce the debt overhang faster, increasing Italy's ability to respond to shocks. The mission recommends an evenly-phased adjustment over 2017–19, net of any remaining upfront costs from structural reforms, that would result in a small structural surplus of about ½ percent of GDP by 2019. Should adverse shocks materialize, automatic stabilizers should be allowed to operate.
- This adjustment path should be supported by policies that give greater priority to more efficient spending and less distortive taxation. Achieving the fiscal targets and creating space to notably lower the still high labor tax wedge may require difficult political choices, including possibly on the high levels of social spending and introducing a modern property tax. Broadening the tax bases, including rationalizing the relatively large tax expenditures, would also be a move in the right direction.