IMF Executive Board Concludes 2010 Article IV Consultation with Italy

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On May 26, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy[i].

Background

The global crisis affected Italy's economy mainly through the trade, credit, and confidence channels. The recession in the country's main trading partners led to a sharp fall in exports. Financing conditions tightened, and credit growth fell. Despite strong household balance sheets, private consumption declined significantly, reflecting uncertainty, and tighter consumer credit. Fixed investment and inventories also fell sharply, reflecting weak demand prospects and difficult financing conditions. The drop in aggregate demand, which was not offset by the comparatively limited fiscal response, resulted in one of the largest output falls among large industrialized countries. However, unemployment rose only modestly, in large part due to wage supplementation schemes and falling participation. A modest and fragile recovery based on external demand, restocking of inventories, and some government support is underway. Output contracted by 5 percent in 2009 and is projected to increase by 0.8 percent in 2010.

The large public debt and the fear of adverse market reactions limited the ability of the government to implement countercyclical fiscal policy. Italy's stimulus package was the smallest among advanced G-20 countries. Nevertheless, the fiscal position deteriorated sharply in 2009. The overall deficit has reached 5.3 percent of GDP in 2009, and public debt increased to about 115.8 percent of GDP by end-2009. The fiscal deficit is projected at 5.2 percent of GDP in 2010. On May 25, 2010, the Italian authorities announced a package of fiscal measures purported to represent a cumulative adjustment equivalent to 1.6 percent of GDP over 2011–12.

The banking system weathered the global financial crisis relatively well, reflecting pre-existing strengths, such as limited exposure to toxic assets, the absence of a property bubble, retail-based business models, and a sound supervisory/regulatory framework. Unlike elsewhere, Italian banks did not need emergency government intervention, and recourse to ECB liquidity support schemes remained limited. However, the deterioration of the economy weakened banks' asset quality and profitability. Credit risk increased during the second half of 2008 and in 2009. Following the economic contraction, lending growth to the private sector slowed sharply, profitability declined, and asset quality deteriorated. Banks increased capitalization in 2008–09, but their capital ratios still range from weak to average compared with other countries in Europe. Banks will need to raise more capital, also in view of forthcoming new regulations and probable increase in non-performing loans.

Executive Board Assessment

The Executive Directors noted that despite the Italian economy's elements of strength such as high private savings, low private indebtedness, and a comparatively resilient financial system, the global crisis had a severe impact on it. Directors commended the authorities for their supportive response to the crisis. Fiscal policy was appropriately tight and timely measures were taken to support the financial sector. The economy is set for a gradual recovery but key weaknesses, including high

public debt and low income growth, remain. The overarching policy goals now should be to maintain fiscal discipline, reduce the burden of public debt, and raise the economy's long-term growth rate.

Directors welcomed the authorities' commitment to reduce the fiscal deficit to below 3 percent by 2012. They strongly commended the fiscal package of measures announced on May 25, which is aimed at achieving this objective. Containing the public sector wage bill should remain a key element of the consolidation strategy and close monitoring of sub-national public finances should be continued.

Directors noted the progress made in improving the fiscal framework, including adoption of the 2009 Accounting and Public Finance law and called for further efforts in this area. The new framework law on fiscal federalism would also have important implications for public finances. Directors stressed that fiscal consolidation should be a key guiding principle in the implementation of federalism. It will also be necessary to tackle longer-term fiscal challenges, including improving the efficiency of public expenditure.

Directors commended the authorities for the recent bold pension reforms, which have significantly improved the sustainability of the pension system. Noting the back-loaded element of the remaining adjustment in benefits, some Directors saw merit in bringing forward the scheduled increase in the retirement age. Efforts to develop private pension schemes should also be intensified.

Directors noted that the financial system had weathered the global crisis relatively well. However, banks could face a number of challenges over the medium term because of the weak economy, future international regulations requiring higher capital, and the continued financial market turbulence in the euro area. Directors therefore recommended that the authorities continue to encourage banks to strengthen capital.

Directors commended the authorities for the progress made in structural reforms but stressed that a more ambitious program of reforms needed to be pursued to address Italy's structural weakness and raise its growth potential. These reforms should be aimed at enhancing competition, boosting productivity, and reducing the high cost of doing business. In this regard, reforming civil justice, accelerating legal processes, and strengthening enforcement of the rule of law were considered critical. Labor market reform would also be necessary to strengthen the link between wages and productivity, allow wages to better respond to regional differences and foster adequate spatial mobility of labor.

Italy: Selected Economic Indicators, 2004–10

	2004	2005	2006	2007	2008	2009	2010

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Real economy (change in percent)							
Real GDP	1.5	0.7	2.0	1.5	-1.3	-5.0	0.8
Domestic demand	1.4	1.2	1.4	1.2	-1.2	-3.5	0.9
CPI (year average, harmonized index)	2.3	2.2	2.2	2.0	3.5	0.8	1.4
Unemployment rate (percent)	8.0	7.7	6.8	6.2	6.8	7.8	8.7
Gross national saving (percent of GDP)	19.9	19.0	19.0	19.4	17.7	15.5	16.1
Gross domestic investment (percent of GDP)	20.8	20.7	21.6	21.9	21.1	18.9	18.9
Public Finance (percent of GDP)							
General government balance	-3.6	-4.4	-3.3	-1.5	-2.7	-5.3	-5.2
Structural balance net of one-offs (in % of potential GDP)	-4.8	-4.6	-3.3	-2.5	-2.6	-3.9	-3.5
Primary balance	1.1	0.1	1.1	3.3	2.2	-0.8	-0.8
Public debt	103.8	105.8	106.5	103.4	106.0	115.8	118.6
Money and credit (end-of-period, percent change)							
Credit to the nonfinancial private sector 2/	5.8	7.7	11.0	9.8	4.9	1.7	...
National contribution to euro area M3 3/	5.1	6.3	7.7	7.6	6.9	5.8	...

Interest rates (end-period)							
6-month interbank rate	2.2	2.6	3.8	4.9	3.7	1.0	...
10-year government bond yield	3.8	3.5	4.2	4.7	4.5	4.1	…
Balance of payment (percent of GDP)							
Trade balance	0.6	0.0	-0.7	0.2	0.0	0.0	0.3
Current account (including capital transfers)	-0.9	-1.7	-2.6	-2.4	-3.4	-3.4	-2.8
Exchange rate							
Exchange rate regime -- euro-area member							
Exchange rate (NC/US$)	1.2	1.2	1.3	1.4	1.5	1.4	…
Nominal effective rate (2000=100)	100.8	100.0	100.1	102.0	104.4	104.5	…
Real effective rate (2000=100)	113.8	112.2	111.9	113.2	115.0	115.8	…
Sources: National Authorities; Eurostat; and IMF staff calculations (April 2010 WEO).							

1/ Staff estimates and projections, unless otherwise noted.

2/ Twelve-month credit growth, adjusted for securitizations.

3/ Excludes currency in circulation held by nonbank private sector

[i] *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. 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.*