INTERNATIONAL MONETARY FUND

Italy: 2008 Article IV Consultation-Concluding Statement of the Mission

November 19, 2008

Italy's economy is being increasingly affected by the global financial crisis. While the banking system is weathering the turbulence relatively well, the crisis is compounding the economy's long-standing, home-grown, weaknesses. To date, the policy responses have been appropriate, and a number of important fiscal reforms have been advanced. Going forward, there is some scope for short-term financial and fiscal actions to counter the impact of the crisis. But it is essential that these be complemented by broad-ranging reforms aimed at ensuring fiscal sustainability and raising the economy's growth potential.

The global financial crisis has further weakened the economic outlook

1. Italy's economy is being increasingly affected by the global financial crisis. In recent months, equity prices have fallen sharply, spreads on bank and government debt have spiked, and wholesale funding markets have dried up. The impact of the global turbulence and the ensuing global slowdown is affecting the already-weak economy: output contracted sharply in the last two quarters; confidence is around historical lows; exports are slowing; labor market trends are flagging; demand for credit is weakening; and financial conditions are tightening. These factors point to negative annual growth in 2008, for the first time in over a decade.

2. The near-term outlook is bleak, despite some insulating factors. Output is projected to fall even further in 2009, given negative carry-over from the recent worse-than-expected quarterly declines, slowing partner country demand, tight credit conditions, and weak confidence. However, the growth decline in Italy is likely to be less severe than in many other advanced economies reflecting the relatively solid banking system, strong household balance sheets, a less inflated housing market, and the industrial restructuring of recent years. In line with the growth slowdown and moderation in international commodity prices, inflation is projected to fall.

3. Negative risks dominate, and the eventual recovery will likely be slow and weak. The main risks to the outlook are a further slowing of global economic activity, given the economy's reliance on exports, and additional falls in consumer confidence. Going forward, the economy's ability to rebound quickly is hampered by pervasive rigidities, lack of domestic competition, the likely slower pace of industrial restructuring, and the limited scope for a fiscal response.

The policy agenda: responding to the global crisis and reinforcing longer-term goals

4. Short-term actions are needed to counter the effects of the global crisis. Given the exceptional nature of the crisis and its repercussions for the domestic economy, some near-term financial and fiscal responses are warranted. But such actions should be tailored to Italy's specific circumstances, especially its high public debt. These responses should also be set in the context of coordinated multilateral initiatives—including the recent G-20 declaration of 15 November—being mindful of international spillovers.

5. The crisis also provides a vital opportunity to address Italy's long-term challenge—the chronic lack of growth. Beyond the present cyclical slowdown, the real economic crisis confronting Italy is

the decline in productivity over the last decade, which has spawned stagnating incomes, rising unit labor costs, a significant competitiveness gap, and tepid growth. The government should thus exploit the early stage of its mandate and its substantial parliamentary majority to complement short-term action with a critical mass of productivity-enhancing measures to kick-start a supply-side transformation, supported by medium-term fiscal consolidation. Indeed, many of the most important economic reforms in Italy and elsewhere in Europe have been spurred by crises.

Preserving financial stability

6. The financial system has weathered the global financial turbulence relatively well. While the crisis has not spared Italy, no financial institution has failed, and CDS spreads for Italian banks remain relatively moderate. This reflects the relationship-based banking model that has supported a broad and stable funding base, low leverage ratios, a comparatively high-quality traditional asset portfolio with little exposure to "toxic" assets, and relatively low dependence on wholesale interbank funding. These factors have been supported by a firm regulatory and supervisory environment, strong intervention and resolution frameworks, and pre-existing high levels of depositor protection.

7. The authorities' response to the financial crisis has been prudent and systematic. Building on already strong practices, the Bank of Italy intensified prudential oversight of risk management, liquidity monitoring, stress testing, targeted inspections, and disclosure enforcement. Measures taken by the Bank of Italy were in line with those defined at the international level, including the recommendations of the Financial Stability Forum (FSF). And the bank support measures adopted by the government in early October—especially the emergency recapitalization scheme, the funding guarantee scheme, the swap facility, and full state underwriting of the deposit insurance schemes—substantially reduced systemic risks, as well as liquidity and funding strains, and set the legal framework for other actions as needed.

8. Yet, as the authorities are well aware, vulnerabilities have risen. Banks' funding maturity mismatch is rising as they rely on relatively shorter-term ECB refinancing and retail bond issues. Capitalization for some banks, while meeting regulatory requirements, is now somewhat lower than that of their peers elsewhere, especially those that have received government-sponsored recapitalizations. As the recession deepens and funding costs rise, credit quality will worsen (with small enterprises likely to come under particular pressure), and profitability will be further squeezed. The largest banks also face a more difficult outlook in Central and Eastern Europe, despite having pursued relatively prudent strategies there. Should the global financial crisis and downturn intensify, so too will these vulnerabilities.

9. Additional measures to strengthen financial stability should be considered. Many of these are already in train and would also help insure against "tail" risks. A voluntary government recapitalization scheme, available to sound banks, could, on balance, play a useful role by supporting investor confidence and minimizing credit tightening. Care should be taken to ensure transparency, minimize market distortions, and limit government involvement in banks' decision-making, including via a clear exit strategy. International experience also suggests that: (1) the operation should be on commercial terms, but not unduly expensive in order to increase take-up by banks, encourage private capital raising, and support credit growth; (2) dividend policy should reflect the need to shore up confidence and repay government holdings; and (3) any conditionality attached should be consistent with full and quick loss recognition. The funding guarantee scheme will also be useful when made fully operational.

10. International coordination will be critical. Italy's advocacy of a more coordinated international approach to crisis resolution and stronger cross-border supervision is particularly welcome. This should be continued, along with Italy's implementation of the international financial reform agenda, including the recent G-20 Declaration, the remaining FSF recommendations and finalizing implementation of EC Directives. The Italian authorities should also be mindful of potential spillovers from their bank support actions for other countries, especially Central and Eastern Europe.

11. The agenda for achieving longer-term financial sector goals should be pursued. Introducing a personal bankruptcy law would important given the weak growth outlook. With banks increasingly reliant on bond issuance to retail investors, efforts to ensure transparency and consumer protection are particularly pressing. The opportunity should also be taken to further strengthen the supervisory and regulatory landscape by finalizing the removal of banks from the ownership of the Bank of Italy and by further enhancing the coordination, efficiency and information sharing among regulators, for example, by reconsidering the so-called "Authorities" law. The work to enhance the Bank of Italy's stress testing to incorporate complex inter-linkages among institutions and with the macroeconomic environment should also continue.

Responding to the crisis while protecting expenditure-based fiscal consolidation

12. The fiscal deficit is set to widen in 2008. The structural fiscal balance improved substantially in 2006-07, mainly due to exceptionally strong revenues, with the overall deficit narrowing to 1.6 percent of GDP in 2007. But, reflecting the expansionary 2008 budget and waning revenue strength, the overall deficit will likely be close to 2½ percent of GDP this year, entailing some loosening in structural terms and a higher expenditure ratio.

13. The government's innovative three-year fiscal package targets a broadly-balanced budget by 2011. This commitment, in line with Italy's undertakings under the SGP, is a positive sign of policy continuity and a key step toward debt sustainability. The adjustment plan is also appropriately expenditure-based and targets a structural consolidation of 0.8 percent of GDP in 2009, and more thereafter, while the public debt and spending ratios are projected to fall. These plans are based on GDP growth rates that rise from 0.5 percent in 2009 to 1.2 percent in 2011.

14. But the near-term fiscal outlook is deteriorating in line with the macroeconomic environment. We project a higher deficit in 2009 due to the weaker growth outlook, while the expenditure ratio would rise further, even if the nominal spending plans are observed. In addition, there are risks that tax elasticities shift adversely during the downturn and expenditure savings will be not be fully realized. The debt ratio will likely rise further, reflecting the gap between the still-high average interest rate on government debt and falling growth rates, higher deficits, and possible bank support operations.

15. Nonetheless, macroeconomic considerations point to scope for reducing the extent of the planned structural consolidation in 2009. This would be in line with the need for a coordinated international fiscal response. While the size of the response should be linked to the extent of the expected economic deterioration, Italy, unlike many other advanced countries, is ill-placed to launch an aggressive fiscal response to the crisis: with its large debt, spiking spreads over Bunds, and the prospect of debt issuance rising globally, delays in adjustment will likely raise interest costs and undermine confidence; Italy's growth problems stem from low potential, not cyclical, growth; and, past relaxations have not been effective.

16. Measures to address the crisis should support longer-term fiscal objectives. While preserving and fully implementing the budget's envisaged reductions in current spending, which are a stepping stone for durable consolidation, timely, temporary and targeted measures should be considered. These could include extending one-off outlays for vulnerable groups (for example, by using the social card or extending tax rebates to the less-well off), bringing forward planned infrastructure maintenance, and reducing government payments delays. Public infrastructure spending, especially accelerating existing projects, could support both short-term demand and longer-term growth if implemented rapidly, transparently, and efficiently, with due regard to fiscal risks—the recent spending review contains useful recommendations in this regard. The measure limiting interest deductibility for banks could also be deferred and its modalities reconsidered. The crisis may present an opportunity to make faster progress in addressing longer-term fiscal challenges, in particular, reforming the welfare system. In any event, the response should avoid being piecemeal and should maintain a credible path to the medium-term objective.

17. The government has taken important steps to improve fiscal frameworks, which are crucial for the viability of expenditure-based adjustment. The budget process has been streamlined and its medium-term orientation strengthened by legislating a three-year adjustment program, advancing key budget decisions, making documentation more transparent and budget execution somewhat more flexible. Welcome efforts are underway to increase the productivity of public administration through measures to contain the cost of public employees and a comprehensive plan to reduce the burden of administration. Measures to improve cost effectiveness in the education sector are being advanced, building on findings from the recent spending review. A draft law on fiscal federalism, which aims at increasing the fiscal autonomy and discipline of all levels of government, is with Parliament.

18. As recognized, these steps need to be built on to achieve longer-term objectives:

- *Deepening budget system reform*: For next year's medium-term plan, the realism of the baseline projections should be enhanced, especially for wages and investment, and fiscal targets should reflect agreements with subnational governments. Other critical reforms should aim to reduce rigidities, including overhauling the 1978 budget law, streamlining the body of legislation that impinges on spending programs, increasing the flexibility in the management of civil servants, and further enhancing the transparency of budget documentation. These measures would be supported by making the spending review process permanent and extended to all ministries.

- *Pursuing prudent fiscal federalism:* Maintaining fiscal discipline will require a transparent, formula-based, system of equalization transfers, a robust and independent regime for monitoring fiscal targets, harmonized accounting, and greater civil service mobility. Regional and local governments should be given more revenue autonomy—in this context, it would be useful to undertake a comprehensive review of property taxation, which internationally is an important local government revenue source. The move to benchmark costing needs to be coordinated with budget system reforms. Should the fiscal federalism reform seem set to result in higher spending or tax burden, bolder cost-saving reforms should be considered, including streamlining the structure of subnational governments.

- *Better managing public sector assets:* The government is appropriately seeking to improve management of public assets, but care should be taken to ensure that the potential proceeds from sales of such assets do not delay consolidation. Faster progress needs to be made on divestment and minimizing the drain on the public purse, with a focus on enhancing competition. These objectives would be helped by ensuring full transparency of any bank-support operations and government guarantees, and producing timely consolidated accounts for the nonfinancial public sector.

Enhancing competitiveness and productivity for a sustainable exit from the crisis

19. The structural reform agenda needs greater prominence and revitalizing. Given the short-term policy pressures, longer-term structural reforms risk being put on the back-burner. Instead, the crisis should be used as an opportunity to take bolder actions aimed at injecting competition and boosting productivity. Some encouraging measures have been taken, including further simplifying legislation, implementing regulatory and competition impact assessments, and passing the local public services bill (albeit falling short of requirements). Building on these, the reform agenda should be expanded, including by adopting the recommendations of the Anti-trust Authority and OECD, focusing on: further liberalizing retail trade and (especially professional) services; continuing deregulation efforts in the energy market; strengthening the role of competition bodies in formulating policy; and eliminating cross-vetoes for infrastructure projects of national interest. The policy agenda and its public acceptance could be strengthened by making greater use of public discussion documents and expert committees.

20. A second generation of labor market reforms is needed. Despite the benefits of earlier reforms, Italy's employment rate remains among the lowest in Europe. Further reforms are needed to strengthen the link between wages and productivity, allow wages to better respond to regional differences, and make permanent contracts more flexible. Broadening and streamlining the social safety net, in particular the unemployment benefit system, could provide timely support for the likely increase in redundancies, as well as scope for increasing flexibility of permanent contracts; it could be financed by reducing replacement rates and eliminating piecemeal measures. In this context, the extension or broadening of "detaxing" overtime and bonus-related pay should be carefully weighed, as should expenditures on active labor market policies, especially in terms of their cost effectiveness and impact on employment. Labor market reform, together with employment growth and real wages, would also benefit from early product market reforms.

21. International initiatives should be leveraged to spur reform. The government's new national reform program aligns priorities for the next three years with the revised Lisbon Agenda's objectives. All levels of government should follow through on these plans, working to reduce the large transposition deficit, including by an ambitious transposition of the EU Services Directive by the end-2009 deadline. Also, any tendencies towards protectionism, for example, creating barriers to foreign ownership of Italian firms, are likely to undermine Italy's economic prospects and should be resisted as affirmed in the recent G-20 declaration.