

International Monetary Fund

Italy—2005 Article IV Consultation Concluding Statement of the Mission

2 NOVEMBRE 2005

1. The Italian economy is at a crucial juncture. Maintaining the current cyclical recovery and raising Italy's low growth potential depend critically on the conduct of policies both before and after April's elections. Over the next several months, the government faces two principal demands: living up to fiscal policy commitments and ensuring the passage of several reforms in train. To this end, the remaining parliamentary calendar should focus firmly on economic priorities. At the same time, the electoral campaign provides an opportunity for a national dialogue on the policies required to create a more competitive Italy. To promote this needed dialogue, the main political coalitions should spell out now the details of their economic programs.

2. Short-term growth prospects have brightened, with signs that the long-awaited cyclical recovery is underway. The marked and broad-based second quarter rebound has been followed by a continued flow of good economic news, with a range of high-frequency indicators turning decidedly positive. We project growth of about ¼ percent in 2005 and slightly over 1½ percent in 2006, with supportive global demand leading to improved net export performance and contributing to a recovery in investment. Employment should also expand, albeit at a slower pace than in the past, as the dividend from previous labor market reforms stabilizes and the impact of the regularization of immigrants wanes. Notwithstanding the sizeable rise in international oil prices, inflationary pressures should remain subdued. But nascent cyclical recoveries have turned into false starts before, and policy steadfastness is called for to help contain downside risks to growth.

3. Improved cyclical prospects should not, however, mask a somber medium-term outlook. Recent debate has focused on concerns about Italy's external competitiveness, particularly in the context of the single currency. Slow growth is often attributed to outside forces, be they euro strength or the pressures of globalization, or to an historical legacy, such as the small, family-owned structure and traditional product orientation of Italian firms. While euro appreciation and increased competition from emerging markets have contributed to weak export performance, the country's economic malaise does not result from some fundamental incompatibility between the Italian economy and the common currency. Moreover, history is not destiny: rather, firm size and specialization are in the long run endogenous, with the resistance of Italy's economic structure to change being a symptom of deep-seated rigidities and inefficiencies in its labor, product, and services markets.

4. Thus, the nation's economic problems are essentially "made in Italy." The fundamental factor accounting for weak competitiveness, and for a decade of disappointing economic performance, is slow productivity growth. Over 1996-2004, growth of output per hour worked was the lowest among all industrial countries, and a cumulative 5½ percentage points below the euro area average. We estimate potential growth at just 1¼ percent per year, with—absent reforms—medium-term prospects further weakened as population aging shrinks the workforce. This continuing poor performance reflects in part economic policy failings over the last decade. The fiscal dividend accruing from EMU qualification in 1997 has been squandered, with the euro-related decline in interest expense being used to finance higher current spending, eroding the primary surplus. Moreover, the borrowing requirement has exceeded the deficit—at times by a wide margin—retarding progress in reducing the public debt ratio, which is set to end this year above its

2002 level. And while pension and labor market initiatives have been noteworthy successes, progress in other areas has lagged.

5. Substantial reforms are therefore essential to raise Italy's growth potential. A successful reform program requires two components—fiscal adjustment and structural change—taking advantage of their complementarities:

- *Expenditure-based fiscal adjustment*, as Italy's staggering public debt and large fiscal deficit divert resources from more productive uses and contribute to uncertainty about future fiscal policies.
- *Structural reforms in product, labor and services markets*, without which increases in enterprise-level competitiveness and productivity will remain beyond reach.

Short-Term Policies: Living Up to Commitments

6. Analysis of fiscal trends and prospects is severely hampered by a long-standing lack of transparency. Recent work by ISTAT, the Bank of Italy, and the Ministry of Economy has narrowed the gap between the cash and accrual deficits, reducing an important element of uncertainty. However, Italy's budget presentation falls well short of industrial country transparency practices, and is in urgent need of improvement. The continued use of the hypothetical *tendenziale* as the budget baseline means that fiscal planning gets off to a murky start. The situation was exacerbated this year by the inclusion within the *tendenziale* of €6 billion of receipts from asset sales, a move that defies the underlying logic of this presentation (although this was subsequently corrected via an amendment to the budget). Moreover, the timeliness of information is unsatisfactory: for example, key details underlying budgetary plans are set out in the so-called "Second Section" of the *Relazione Previsionale e Programmatica* (RPP), generally available only well after the RPP itself. Given the depth of the country's fiscal challenges, a permanent Independent Fiscal Council of leading experts should be established to evaluate budget proposals and trends and stimulate a debate on fiscal issues, building on the useful work performed by the *Corte dei Conti* and other entities.

7. The "manovrina" for 2005 and the recent budget amendment for 2006 are welcome expressions of the government's commitment to its fiscal targets. For 2005, the *manovrina* provides reasonable confidence that the deficit target of 4.3 percent of GDP will be achieved, though margins remain tight. Delays in renewing some public sector wage contracts, which will defer their fiscal impact to 2006, will also help contain the deficit this year. Along with the revenue effect of the incipient recovery, this should be sufficient to offset shortfalls in programmed asset sales and some slippage in current spending. Even with the target's observance, however, the public debt ratio will rise and current primary spending will increase by an estimated 0.6 percent of GDP, highlighting the strong underlying expenditure dynamics at play.

8. The 2006 budget has a number of positive features. First, the budget is based on a realistic macroeconomic scenario with respect to growth and other key variables. Indeed, growth may slightly exceed the budget forecast, providing moderate additional revenue support, especially as the budget's revenue estimates are appropriately conservative. Second, adjustment is based primarily on expenditure measures, rather than tax increases or one-off revenue items. Third, despite the imminent elections, the budget demands considerable restraint from both central and local governments.

9. We are concerned, however, that Italy's public expenditure dynamics will undermine achievement of the 2006 deficit target of 3.8 percent of GDP. In the first place, the slippage of wage contract renewals is not provided for in the 2006 budget, with a net impact on the deficit of about 0.2 percent of GDP. And there are other concerns:

- The budget envisages deep cuts in central government current spending. With underlying determinants unaltered, irrepressible pressures are likely to arise.
- The budget assumes rigorous expenditure control at the local level. This is notably true for health care, where such control has been elusive. Firm implementation of initiatives to contain health costs (such as the *tessera sanitaria*, the *Agenzia del Farmaco*, and mechanisms to increase local and personal accountability) will be essential, but savings from some initiatives depend on behavioral changes, which typically materialize slowly.
- Finally, the drastic cuts in transfers to the railways and ANAS will be difficult to sustain without credible corporate restructuring, which is in turn complicated by the lack of timely information on the firms' financial situations.

10. Every opportunity to strengthen the budget further should therefore be seized. With the budget law still under discussion, such opportunities exist. As a starting point, the affordability and necessity of the budget's spending initiatives should be critically re-assessed. Following approval of the budget, careful monitoring and firm resolve in its execution will be of the essence, including to ensure that the electoral calendar does not lead to an undue front-loading of expenditures next year. Any revenues arising from higher-than-budgeted asset sales should go to deficit reduction, rather than higher spending.

11. While the budget process is likely to absorb most of the remaining legislative session, key reforms pending in Parliament should be expeditiously approved. The reform of the bankruptcy code, designed to simplify and accelerate procedures and provide debtors with a fresh start, is a welcome improvement over the present antiquated law. The reform of civil procedures will also promote efficiency. The Savings Law, originally intended as a rapid response to corporate scandals, has languished in Parliament and has undergone substantial amendment—not always for the better. It nonetheless includes advances in corporate governance, in the marketing and issuance of corporate bonds, and in coordination among regulatory agencies. It, too, should be approved in the current legislative session. We have also long supported a reform to promote private pension savings, to help address the rising costs of population aging. Use of severance payments (TFR) is one way forward, though care should be taken to ensure that any reform meets the needs of investors for a safe and fair return, and ensures full transparency, appropriate supervision, and adequate competition. In the future, attention should also be given to developing private pension instruments for workers without access to severance funds. Finally, the adjustment of pension replacement rates in response to changes in life expectancy should be implemented this year, as mandated under the 1995 pension reform.

12. The Savings Law also contains initiatives to improve the Bank of Italy's governance and increase its accountability, which is not commensurate with its appropriately high degree of autonomy. Proposed steps in this direction, including limiting the Governor's term of office and enhancing transparency in the exercise of the Bank's functions (such as via semi-annual reports to Parliament and the Government) are welcome. In addition, consideration should be given to incorporating the points made by the Governing Council of the ECB (including extending the fixed term of office to all members of the Directorate and increasing collegiality in decision-making). In the transition to a new ownership structure, central bank independence must be fully safeguarded.

The Medium-Term Agenda: Creating a More Competitive Italy

13. The post-electoral priority should be to create a more robust, flexible and dynamic economy, able to compete in a globalized world. This will require an unequivocal commitment to reforms that enhance competition, reduce price mark-ups, and promote freedom of choice, including by dismantling systems that protect economic rents of various insider groups at the expense of the public at large. The main focus should be on product and services markets, complementing existing labor market reforms. Many of these reforms will have low budgetary costs, and can be pursued despite the tight fiscal position. Progress with product market reforms to reduce prices will also help cushion the impact of wage moderation on worker incomes.

14. There is a need for a suite of complementary reforms, focused on those with clear employment and growth effects, in a variety of areas:

- *Product markets*, where protection offered to sectors like retail trade and a lack of competition in key network sectors raise the costs of doing business. In retail trade, while competencies have been devolved to lower levels of government, the state should use its remaining responsibilities to promote consumer welfare through greater competition. Further deregulation in network sectors, as well as a move away from instruments such as "golden shares" and "poison pills," and enhanced powers for the antitrust and sectoral authorities—under an institutional framework and nomination procedures that ensure their independence—should be priorities. Among the professions, rules that inhibit competition (including by prohibiting nonprofessionals from performing relatively nontechnical services), establish minimum tariffs for certain activities, and restrict transparency by barring advertising, should be eliminated. In addition, planned reforms to the role of notaries—which were regrettably dropped—should be reinstated. Rapid implementation of the EU services directive, when finalized, would also promote competition and efficiency. Italy's poor record in transposing EU directives more generally should be improved.

- *Labor markets*, where despite advances there is scope for more flexibility, as reflected in still-low participation rates, especially for women and the young. The progress in implementing the Biagi reforms is welcome. Recent measures improving unemployment compensation should be precursors to a fundamental overhaul of Italy's protection system (*ammortizzatori sociali*), offering better and properly conditional unemployment support accompanied by a relaxation of employment protection legislation. Furthermore, greater variation of wages in line with productivity differences is critical to redress competitiveness losses in the short term, as more fundamental changes in the economy will take time to bear fruit. Italy continues to fall short of the EU average in many measures of human capital, and progress is needed here, as well.

- *The business environment*, where cross-country data compiled by various international bodies indicate that Italy still lags on many fronts. Enhancing the delivery of public services, accelerating legal processes (to which the pending reforms of the bankruptcy code and civil procedures will contribute), streamlining bureaucratic requirements, improving the quality of public investment and infrastructure, and strengthening enforcement of the rule of law where necessary can reduce the so-called "Italy Cost" (the perceived higher cost of doing business in Italy), particularly in the South.

The government's recently released *Piano Nazionale per l'Innovazione, la Crescita e l'Occupazione* stresses the need for progress in many of these areas, and provides a useful contribution to the debate over the policies to take Italy forward.

15. Restoring the sustainability of the fiscal accounts is also a *sine qua non* for faster growth, and is complementary to structural reforms. Clearly, faster growth will allow a more rapid

reduction in the debt ratio. At the same time, deficit reduction is an important element of a strategy to enhance Italy's growth potential. The commitment to reduce the deficit to below 3 percent of GDP by 2007 is welcome, but is insufficient to ensure sustainability of the fiscal accounts, especially in light of pressures that will arise from population aging. The next update of Italy's Stability Program should commit to a path of annual deficit reduction that will ensure overall fiscal balance by 2010, before the end of the next legislature. Budget balance was the medium-term objective of earlier updates, but the decision to tolerate, rather than correct, subsequent budget slippages has pushed its achievement beyond recent programs' horizons. It is time to re-establish it as a goal.

16. To be credible, adjustment should be centered on expenditure containment. The steady growth in primary current spending since the late 1990s—at an annual average rate of 2 percent in real terms—lies at the heart of Italy's current fiscal fragility. Reversing this trend will require a targeted approach to expenditure rationalization within a medium-term budget framework, and could involve reductions in subsidies to firms, a rationalization of public employment, and reforms to enhance the efficiency of public procurement, beyond outright cuts in spending on non-essential goods and services. The planned nationwide implementation of SIOPE will provide a powerful tool to monitor cash outlays, and should continue to be strongly supported. Over time, a reduction in spending could also create scope for cuts in labor taxes, further stimulating output and employment growth.

17. The ongoing devolution of functions from the central government highlights the need for a properly designed system of fiscal federalism. To be successful, devolution must be accompanied by mechanisms that allow local governments to raise their own taxes (within an appropriate equalization framework), creating incentives to be fiscally responsible. The recently completed work of the High Commission on fiscal federalism could form the starting point for designing this reform. Stable and transparent rules would allow local governments to prioritize spending in a medium-term framework.

The Financial Sector

18. A competitive financial sector is also critical to support faster growth and a more vibrant economy. The recently-concluded Financial Sector Assessment Program (FSAP) mission found Italy's financial system to be generally sound. The banking sector has proven resilient to slow output growth and stress tests indicate little vulnerability to unfavorable macroeconomic shocks. However, a number of structural weaknesses limit the role of the financial system in promoting growth, including high fees and commissions, undersized corporate bond and equity markets, and a predominantly relationship-based orientation that favors incumbents over new entrants.

19. In addition, some specific issues emerged from the FSAP that deserve attention:

- Market contestability is limited. Greater contestability would make the financial sector more dynamic, yielding significant efficiency gains.
- Loan classification standards are more lenient than those in other industrial countries. Aligning Italy's definition of impaired loans with international norms would better reflect underlying realities and provide more meaningful information on banks' financial health. This would reduce measured asset quality, increase provisioning needs (which are already relatively large, as even under current standards nonperforming loans are comparatively high), and weaken measured profitability.

- Regulation of lending to related parties is insufficient. This creates uncertainty about the extent of connected lending, which should be monitored closely. Welcome steps by the Inter-Ministerial Committee on Credit and Savings (CICR) to approve broad guidelines on connected lending should pave the way for the Bank of Italy to issue more detailed regulations and to monitor the impact of such lending on bank balance sheets.
- Liquidity buffers in the banking sector have decreased to levels significantly below those in other industrialized countries. The authorities should continue to monitor banks' vulnerability to liquidity risk and, if necessary, require them to raise liquidity buffers.

20. The institutional set-up governing responsibilities for banking system supervision and competition must ensure the maximum levels of transparency and accountability. The Bank of Italy is assigned three broad statutory objectives: maintaining financial system stability, enforcing anti-trust laws, and promoting banking sector efficiency and competitiveness. Recent developments have raised concerns about potential conflicts among these objectives, leading to proposals to entrust competition to a different institution, as in most countries. Such a clear-cut demarcation of responsibilities would address the above concerns; it would, though, require preparatory efforts to transfer expertise and resources to the recipient authority, and strengthened guarantees of its independence. Should the Bank remain in charge of competition, as envisaged under pending legislation, its focus should be defined as such, dropping the reference to "competitiveness" in the Banking Law. More importantly, there should be a clear delineation of responsibilities and distinct accountability mechanisms for the remaining policy areas (stability and competition). Furthermore, when announcing its decisions, the Bank should disclose the policy objective it is pursuing, and the procedures and internal criteria on which the decision was based.