INTERNATIONAL MONETARY FUND

2012 Article IV Consultation with Italy- Concluding Statement of the IMF Mission[1]

May 16, 2012

AN AGENDA FOR REVIVING GROWTH IN ITALY

With broad political support, the authorities have embarked on an ambitious and wide-ranging agenda that has lifted Italy from the brink and is now seen as a model for fiscal stabilization and growth-enhancing reforms. However, the work has only just begun, and a lot remains to be done to revive growth and restore dynamism to the economy. The emphasis should continue to be on comprehensive structural reforms to boost productivity and labor participation, a supportive fiscal strategy that is both growth-friendly and sustainable, and steps to promote a more dynamic and resilient banking system. Italy's success also depends on progress at the European level to resolve the crisis and promote growth.

1. The economy is expected to contract this year due to strong headwinds from fiscal consolidation, tight financial conditions, and the global slowdown. Economic activity is expected to recover in early 2013, led by a modest pickup in exports and investment. Headline inflation is expected to ease only gradually, as the impact of weak demand will be partly offset by higher indirect taxes.

2. The risks to the outlook are tilted to the downside. Renewed financial turmoil could push government bond yields higher, tighten bank credit, and weaken activity. Slow progress in implementing needed fiscal and structural reforms could undermine confidence and raise concerns about Italy's fiscal position. On the upside, a more robust global recovery or faster progress in reforms could boost market sentiment and activity.

3. Italy's outlook also depends on continued progress at the European level in creating a more complete monetary union. A more integrated euro area with greater fiscal and financial discipline and risk sharing would provide a more durable solution to the euro area crisis and, combined with further monetary easing and unconventional measures as needed by the European Central Bank (ECB), support Italy's adjustment efforts.

4. Maintaining the momentum for reform will be important to address stagnant productivity and entrenched structural weaknesses that have constrained Italy's medium-term growth potential. The difficult business environment, fragmented labor market, and limited competition in services have contributed to the poor growth performance and a loss in competiveness. The high level of youth and long-term unemployment risks creating a "lost generation" with lasting consequences for growth. Addressing these weaknesses is a key priority for reviving growth and alleviating the social cost of the crisis.

I. Structural Reforms to Jumpstart Growth

5. The potential gains to growth from deeper structural reforms are substantial. IMF staff estimates suggest that product and labor market reforms that bring Italy closer to OECD best practices could increase the level of GDP by about 6 percent over the medium term. The government has embarked on important reforms to deregulate the service sector and make the labor market more inclusive and flexible. Accelerating these reforms, and locking in now the necessary legislative and administrative changes, would strengthen confidence and create momentum for further reforms. Greater coordination at the EU level, especially in strengthening the single market for energy, transportation, and services, would also support Italy's efforts in these areas.

6. The labor market reform bill should be passed quickly to reduce uncertainty and encourage new hires. The bill promotes open-ended and apprenticeship contracts for young workers and makes unemployment insurance more universal. It also facilitates hiring by allowing companies to lay off workers for economic reasons and reducing the cost of dismissal. Clarifying further the conditions for reinstatement via the judicial process would reduce uncertainty and facilitate out-of-court settlements of dismissal disputes.

7. More is needed to bridge the gap between permanent and temporary workers and address the high unemployment of youth and women. The cost of new regular hires could be lowered by allowing for a more flexible open-ended contract for new workers that gradually increases employment protection with tenure. This would also facilitate the employment of young workers. Reducing the marginal tax rates for married second-earners would help raise female labor participation (one of the lowest in the OECD). Allowing companies and workers to first set firm-level contracts, unless they agree to opt out and abide by national ones, would better match wages to productivity, while greater differentiation of public wages across regions would support private wage flexibility and employment, especially in the South.

8. In product markets, priority should be given to accelerating reforms in the energy, public and professional services sectors with the broadest impact on growth. Completing the planned separation of gas distribution and production by end year would improve competition and eventually help drive down energy prices, which are among the highest in the euro area. Accelerating the opening of professional orders would also strengthen competition and lower rents. A greater push for privatization, especially for local public utilities, would enhance the efficiency, cost, and quality of public services. Increasing the efficiency of the judicial system would have wide-ranging benefits for reducing the backlog of legal cases, lowering business costs and uncertainty, and strengthening labor market reforms.

9. Helping small and medium-size enterprises (SMEs) grow would facilitate the shift of resources to new growth areas. Reducing the high cost of startups and streamlining tax and other regulations would lower business uncertainty and costs. Expanding risk-based—as opposed to collateral-based—lending would improve SMEs' access to credit, while developing further the venture capital and private equity industry would expand the availability of risk capital. Recent initiatives to foster firm recapitalization, such as the allowance for corporate equity, are welcome in this regard. In addition, reforms to promote greater inward FDI (among the lowest in the OECD) would allow SMEs to benefit from the growth in global supply chains and technology transfer.

II. Making Fiscal Consolidation More Growth-Friendly

10. The government has enacted an impressive fiscal package to improve the primary surplus. The package features significant and front-loaded consolidation; pension reforms to strengthen long-term sustainability; a modest shift from direct to indirect taxes (in support of a so-called "fiscal devaluation"); and more aggressive action against tax evasion. As a result of these measures, the primary surplus of the general government is expected to rise significantly, to above 4 percent of GDP by 2013, the highest in the euro area.

11. The fiscal adjustment this year and next is appropriate. The sizeable improvement in the structural primary balance in 2012–13 will weigh heavily on growth but is critical for fiscal sustainability. The mission welcomes the increased focus on targeting a structural balance which adjusts for the economic cycle and allows fiscal policy to remain flexible in a more severe downturn. To bolster the recovery, the mission welcomes the government's efforts to identify and implement the needed expenditure cuts to avoid an increase in the VAT rate later this year.

12. Shifting further the composition of adjustment towards expenditure cuts and lower taxes would better distribute the burden of adjustment, thereby supporting growth. Cutting government expenditure, such as the public sector wage bill or other areas identified in the ongoing spending review; reducing Italy's sizeable tax expenditures; and stepping up efforts against tax evasion would create space for growth-supporting measures. These measures could include: reducing the labor tax wedge to boost employment; raising the allowance for corporate equity to encourage investment; or financing a modest, well-targeted increase in public infrastructure investment. Staff estimates that a sizeable shift in the composition of adjustment could raise the level of GDP by 1 percent over the long term.

13. The newly adopted constitutional fiscal rule is an important instrument for strengthening fiscal discipline and policymaking. Adopting a binding multi-year expenditure framework and unifying and enhancing the role of spending reviews in the budget process would buttress the credibility of the fiscal rule. The fiscal council will be important in assessing fiscal developments and improving accountability, and should be set up fully independent in terms of staffing, funding, and work agenda.

14. Locking in prudent fiscal policies over the medium term would improve confidence and support growth. Looking beyond 2013, the ongoing spending review should expeditiously identify further cuts to unproductive expenditure and use some of the savings to reduce debt. With the debt-to-GDP ratio projected to decline only gradually, the fiscal position will remain vulnerable to market distress or an economic slowdown. To raise the buffer against such shocks, targeting a 1 percent of GDP structural surplus from 2014 onwards as the medium-term anchor for the fiscal rule would put the debt ratio on a more robust downward path, even under adverse conditions. The credibility gains from a faster pace of debt reduction could lower borrowing costs significantly, especially once European market conditions stabilize.

15. The stock of outstanding public payments needs to be addressed. Completing quickly the stocktaking exercise to determine the size of pending and overdue payments at the central and subnational levels, along with a strategy for improving the reporting and timeliness of public payments, would strengthen expenditure control and accountability. Such a strategy should be complemented by improved coordination among all levels of government and continued incentives for fiscal prudence also at the subnational levels.

16. The debt management strategy should seek to maintain the favorable maturity structure of debt and diversify the investor base. Moving to provide collateral in swap transactions would further strengthen financial stability. Subsequent regular reporting of such transactions in government accounts would enhance transparency. In addition, the authorities should assess the scope to mobilize public assets, including through privatization and other means, to maximize revenue generation and reduce public debt.

III. Promoting a More Dynamic and Resilient Banking System

17. Italian banks continue to benefit from their large and stable retail funding base, low leverage, and traditional lending model which has limited exposures to risky assets. The resilience of the system has been supported by firm supervision and regulation. Italian banks weathered the global financial crisis and strengthened their capital base without large-scale equity support from the government.

18. Despite these strengths, banks remain pressured by concerns about the economic outlook and link with the sovereign. Gross impaired loans (including bad, substandard, restructured, and past-due loans) have risen to 11 percent in 2011, from less than 6 percent before the crisis. Together with a decline in provisioning rates below the pre-crisis levels, this leaves Italian banks vulnerable to the downturn, especially from the weaker SME and construction sectors. Exceptional liquidity support from the ECB has been critical for meeting banks' funding needs and has helped prevent a sharp contraction of credit.

19. Reducing impaired loans would free up resources for new lending. Banks' buildup of impaired loans reflects both an inefficient legal process that delays loan write-offs and the flow of new bad loans arising from the slowdown. The growing stock and slow pace of disposal have constrained core profitability and tied up funding and capital. Supervisors should encourage banks to develop strategies for selling, restructuring or writing down impaired loans to free up resources for lending. The development of a market for restructuring distressed assets could be facilitated by ensuring adequate bank provisioning, aligning more closely tax deductibility of loan loss provisioning and write-offs, and streamlining bankruptcy and foreclosure procedures.

20. Banks should maintain adequate capital and liquidity buffers to remain resilient to the downturn. The Bank of Italy (BoI) should continue to encourage large banks under the European Banking Authority (EBA) to meet their capital needs by raising equity or disposing of noncore assets, rather than cutting loans. To further enhance transparency, the BoI should consider extending its stress tests to a larger set of institutions, including mid-sized banks, and publish the results in its regular *Financial Stability Reports*. This would help market participants assess banks' capacity to withstand a slowdown and funding distress and anchor market discipline. Encouraging banks to improve their capacity to post eligible collateral at the BoI would facilitate access to Eurosystem liquidity facilities.

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We are grateful to the authorities and our counterparts for their hospitality and open and constructive discussions.

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[1] An IMF team visited Italy from May 3 to May 16, 2012, for the annual evaluation of the economy as part of the regular consultations under Article IV of the IMF's Articles of Agreement. This statement describes the preliminary findings of the staff.