2013 Article IV Consultation with Italy

Concluding Statement of the IMF Mission[1]
July 4, 2013

BEYOND AUSTERITY: PRIORITIES FOR REVIVING GROWTH

The authorities have taken bold steps since the late 2011 crisis to strengthen the public finances and transform the economy. The difficult reforms were necessary to restore confidence and bring Italy back from the brink. But growth prospects remain weak, unemployment is unacceptably high, and market sentiment is still fragile, underscoring that the task is far from complete. The new government has started to build on the steps taken to tackle Italy's structural problems. Accelerating the momentum for reform will be essential to jumpstart growth and create jobs. Europe will also need to play its part with actions to address financial fragmentation and strengthen further the currency union.

A Difficult Recovery

1. The economy is showing signs of stabilizing, but strong headwinds are still holding back the recovery. Business and household confidence have picked up but have yet to lift activity and employment. And while sovereign pressures and the pace of fiscal adjustment have eased this year, financial conditions remain tight, restraining private spending. Looking ahead, growth is projected at -1.8 percent this year, before recovering to 0.7 percent next year. The recovery is expected to start in late 2013, supported by exports and a modest turnaround in investment led in part by the clearance of public arrears.

2. The risks to the outlook are tilted to the downside. Policy slippages, including at the European level, could undermine market confidence in the sovereign, intensify funding pressures on the banks, and tighten credit. A prolonged recession would further increase banks' nonperforming loans (NPLs), especially for the weak SME and construction sectors, and raise concerns about the country's fiscal position. Outside Italy, a slowdown in the emerging market economies or market turmoil could jeopardize an export-led recovery and push up sovereign and private interest rates.

3. Italy's growth prospects over the medium term will strengthen only with the implementation of comprehensive reforms. The euro zone crisis hit Italy hard, but the seeds of Italy's low growth pre-date the crisis and follow from its stagnant productivity, difficult business environment, and over-leveraged public sector. Accelerating reforms to address these structural weaknesses will be crucial to limit the risks of long-term unemployment, especially for the youth, and raise Italy's trend growth.

I. Structural Reforms to Improve the Business Environment

4. More effort is needed to boost the economy's low productivity and declining competitiveness. The economy's weak recovery since the crisis also highlights its lack of flexibility in responding to shocks and global changes. Factors include the high entry barriers and regulatory hurdles that have increased margins, especially in services, and the high cost of electricity (up to 40 percent greater than in France and Germany) that have undermined Italy's competitiveness. The lengthy and inefficient justice system has also been linked to the high cost of doing business, low inward FDI, as well as the small size of firms and capital markets. While progress has been made in reforming the labor market, opening the gas sector, and liberalizing some professional services—the agenda is not complete, and implementation will be key:

> *Product markets*. Steps to appoint transport regulators, enhance competition in the electricity sector, and reform the legal profession should be completed quickly.

Public services. The privatization agenda, especially at the local level, and the spending reviews to enhance public administration efficiency should be implemented quickly. The new anti-corruption law is an improvement, and further strengthening of the legal framework and effective implementation will be crucial.

Judicial reforms. The government has taken important steps to reorganize the court system, introduce compulsory mediation, and address the significant backlog of cases. A comprehensive review of all court fees and further aligning of the grounds for appeals with international practice will also improve judicial efficiency.

5. Priority should also be given to raising Italy's low employment, especially of youth and women. Closing half the employment gap with the rest of Europe (some 4½ percentage points) could lift the level of GDP by as much as 2½ percent by 2018. To support employment, priority should be given to improving the coordination and efficiency of active labor market policies and employment services at the local level which would support the youth guarantee program starting next year. Shifting to a more flexible, single contract for new workers that gradually increases job protection with seniority could lower the cost of new hires and support apprenticeships. Encouraging companies and workers to set firm-level contracts would better match wages with productivity. Lowering the marginal tax rate for married, second earners could also lift labor participation, especially for women which, at 50 percent, is one of the lowest in the OECD.

II. Fiscal Policy—Reducing Vulnerabilities and Supporting Growth

6. Italy is set to reach its target of structural balance this year. The sizeable fiscal adjustment in 2012 weighed heavily on growth but was crucial for Italy to exit the EU Excessive Deficit Procedure. Achieving one the highest primary surpluses in the euro area last year was a key factor in strengthening policy credibility and confidence. This will allow fiscal policy to target a structural balance this year which will provide automatic flexibility to the economic cycle if needed.

7. A rebalancing of fiscal adjustment is urgently needed to support growth. Effective implementation of the government's efforts to accelerate the payment of arrears, up to the amount of 40 billion euro over the next 12 months, could significantly ease firms' credit constraints. The renewed efforts to legislate the *Delega Fiscale* are also welcome and should improve the efficiency of the tax system. But more can and should be done quickly to support growth, by rebalancing the composition of adjustment towards expenditure cuts and lower taxes:

Spending reviews. Over recent years primary expenditure declined by nearly 2 percent in nominal terms. Efforts to cut spending should continue with the budget starting in 2014, by implementing a more comprehensive spending review focused on improving the efficiency of public spending and finding additional savings to lower taxes.

Broadening the tax base. The spending reviews should be undertaken jointly with a systemic review of tax expenditures. The property tax on primary residences should be maintained for equity and efficiency reasons, and the review of cadastral values accelerated to ensure fairness. Stepping up efforts to combat tax evasion, including through better use of anti-money laundering tools, and increasing the inheritance tax would also raise revenue and more fairly distribute the tax burden.

Lower marginal tax rates on labor and capital. Savings from the above measures would help achieve the government's objective of reducing the high tax on labor (4 percentage points of GDP higher than the euro area average) to boost employment and raising the allowance for corporate equity returns (ACE) to spur investment.

Public investment. Measures are being taken to speed up public infrastructure investment. If space allows, a modest, well-targeted increase in public infrastructure investment could catalyze private spending.

8. Vulnerabilities from the high public debt underscore the importance of a high primary surplus. Despite the strong fiscal effort in 2012, the public debt ratio is projected to be significantly higher than a year ago, primarily due to the weak economy and also the clearance of public arrears. To reduce vulnerabilities to an economic shock and support confidence in the sustainability of the public finances, the authorities could consider gradually building a structural surplus buffer above the balance in the new fiscal rule after 2014—once the economic recovery is firmly underway.

9. Stronger budget institutions will enhance the credibility of the fiscal anchor and improve the efficiency of expenditure. In particular, binding multi-year expenditure ceilings will more effectively guide budget planning by ministries and sub-national governments and enhance discipline. The setting up of an independent new Parliamentary Budget Office with professionally qualified board members from January 2014 will be crucial.

III. Banking sector—Strengthening Balance Sheets and Lending

10. The recession has eroded Italian banks' asset quality and profitability. The ratio of nonperforming loans has almost tripled since 2007, while provisioning coverage has declined. Lower sovereign yields have boosted banks' trading gains, but core profitability remains weak, as rising loan losses have absorbed nearly all operating profits. In contrast to other large countries in Europe, bank credit continues to contract and lending rates remain high, especially for SMEs.

11. Accelerating write-offs of bad loans would clean up banks' balance sheets and support lending. The high stock of NPLs reflects both an increase in the flows and the slow pace of write-offs (6 years on average). Reducing the burden of NPLs would improve confidence in Italian banks and release resources to support lending. Policies to assist banks in developing strategies for selling, disposing, or writing down impaired loans should look to:

Enhance provisioning / write-offs. The Banca d'Italia (BoI) has taken appropriate measures—which it intends to continue—to strengthen provisioning through its inspection last autumn of 20 large and medium-size banking groups which has arrested the decline in provisioning coverage since the crisis. Expanding the BoI inspections to cover more impaired and performing loans as well as smaller banks would strengthen provisioning further. These measures will help banks be prepared for the forthcoming ECB/EBA asset quality review and stress tests. Publishing the general findings of the inspections, including guidance on provisioning, would encourage banks to converge to best practices and enhance market confidence. Ensuring a minimum level of harmonization and strengthening prudential considerations in write-off practices could also accelerate NPL disposal.

Increase tax deductibility of loan losses. Allowing for full deductibility of new loan loss provisions and as fiscal space allows, accelerating deductibility on old ones would encourage more provisioning and write-offs, thereby facilitating lending.

Expedite the judicial process. Expanding the use of specialized insolvency courts beyond Milan could reduce the time in solvency, while greater reliance on on-line court filings and decisions could accelerate the collateral foreclosure process. Introducing best practice guidelines on workouts would encourage more out-of-court restructuring.

12. Ensuring adequate capital and liquidity buffers would strengthen bank lending. Italian banks have bolstered their capital positions in recent years. The stress test results of the IMF's Financial Sector Assessment Program (FSAP) found the overall level of capital in the system as a whole to be well above regulatory minima and sufficient to absorb the additional requirements of Basel III. [2] But given the low level of profitability, in an adverse macroeconomic scenario, the extra capital buffers would be quickly depleted. Targeted action to improve bank profitability and efficiency and to strengthen capital plans where needed would shore up the defenses of Italian banks and strengthen their lending capacity.

13. Corporate governance of the banking sector should be enhanced. Foundations should have in place proper governance frameworks, including a cap on leverage, strict disinvestment procedures, and more effective fit and proper tests for bank directors and controlling shareholders. The largest cooperative banks should also be encouraged to convert to joint stock companies. The authorities should monitor closely the implementation of Banca Monte dei Paschi di Siena's restructuring plan and be prepared to take action expeditiously if the bank fails to meet its targets.

14. A more robust framework for financing SMEs would help ease credit constraints. Initiatives, such as the launch of mini-bonds, lending support from the Cassa Depositi e Prestiti, and expansion of the Central Guarantee Fund have eased SME credit constraints. At the same time, the government should monitor the expansion of public credit guarantees and strengthen the fee system to limit moral hazard. SME securitization and covered bonds could be expanded to facilitate SMEs' access to credit, with potential support from the ECB through a reduction in collateral haircuts.

The Role of Europe

15. Italy's efforts should be complemented at the euro area level with steps to strengthen the currency union and support growth. Direct asset purchases by the ECB, such as for SME credits, another LTRO of considerable tenor, and lower haircuts on eligible collateral would help lower bank funding costs and lending rates. Greater progress in the banking union, especially the single resolution mechanism and ESM backstop, would help sever the sovereign banking link. Moves to strengthen the common market, such as the Services Directive, would enhance the cross-border benefits of reforms. Progress in European policies combined with vigorous reforms in Italy would go far in producing a more vibrant and dynamic currency union.

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[1] An IMF team visited Italy from June 24 to July 4, 2013, 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.

[2] More in-depth analysis and recommendations to strengthen financial sector supervision and improve Italy's financial safety nets will be covered in the forthcoming Financial System Stability Assessment, which summarizes the findings of the FSAP, and will accompany this year's Article IV consultation report.