

**Italy: 2005 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Italy**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Italy, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 2, 2005, with the officials of Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 6, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of February 1, 2006 updating information on recent economic developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2006 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Italy.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

ITALY

**Staff Report for the 2005 Article IV Consultation**

Prepared by the Staff Representatives for the 2005 Consultation with Italy

Approved by Michael Depler and Michael Hadjimichael

January 6, 2006

- Messrs. Leipold (head), Drummond, Gerson, and Lissovolik (all EUR), Ms. Fedelino (FAD) and Ms. Sgherri (EUR) visited Rome October 19–November 2, 2005. They met with the Minister of Economy and Finance, the Deputy Director General of the Bank of Italy, and other representatives of the central and local governments, regulatory agencies, financial entities, labor and business organizations, academia, and economic spokespersons for opposition parties. Mr. Ferhani (MFD) joined the mission to discuss the results of the FSAP exercise. Mr. Sadun (Executive Director) attended most meetings.
- The center-right coalition has been in power since 2001. Parliamentary elections are scheduled for April 2006.
- Italy has accepted the obligations of Article VIII, Sections 2, 3 and 4, and maintains an exchange system free of restrictions, except for those maintained solely for the preservation of national or international security, and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51); see Appendix 1.
- The mission chief and Minister of Economy and Finance held a joint press conference at the conclusion of the mission. The authorities intend to publish this report.
- Data provision to the Fund is adequate for surveillance purposes.

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## Executive Summary

*A mild cyclical recovery is underway, but medium-term prospects are troubling. Potential growth is estimated at just 1¼ percent annually, amid a steady deterioration in external competitiveness. The fiscal deficit exceeded 4 percent of GDP in 2005 and the public debt ratio—already among the highest in the world—is on the rise again. Significant expenditure-based fiscal adjustment and broad-based structural reforms to eliminate rigidities that raise domestic costs and discourage innovation and entry are essential to ensure the sustainability of the fiscal accounts and enhance competitiveness and potential growth.*

***A cyclical recovery is expected to continue in 2006.*** Owing to the recession at the turn of 2004, growth is estimated to have been just above zero in 2005, but a consolidation of current trends is projected to result in growth of about 1½ percent in 2006. Sluggish demand should keep inflationary pressures in check.

***The authorities will need to ensure Italy lives up to its commitment under the Excessive Deficit Procedure (EDP) to achieve a deficit of 3.8 percent of GDP in 2006.*** The authorities have introduced a number of measures that they believe are sufficient to ensure an appreciable overperformance. However, there is a significant risk that the envisaged deep expenditure cuts will be difficult to sustain, and the staff's central projection envisages some slippage from the EDP target.

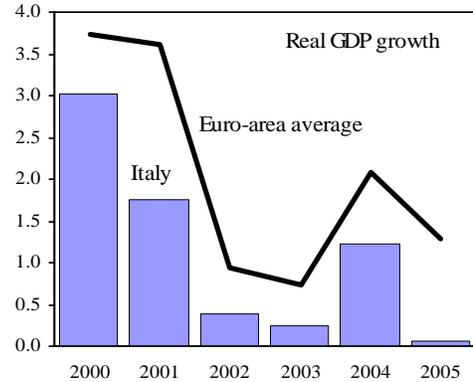
***A more ambitious medium-term path of fiscal adjustment is critical for debt sustainability.*** Staff simulations show that reducing non-age related spending to a level consistent with achieving overall budgetary balance by 2010 is necessary for stable debt dynamics. Realizing the required spending cuts—about ¾ percentage point of GDP annually in structural terms—will demand targeted expenditure reduction within a medium-term budget framework.

***A bold structural reform agenda to create a more competitive Italy is paramount to boosting long-term performance.*** A number of recently-approved reforms—including to the codes for bankruptcy and civil procedures and a “savings law” that enhances corporate governance, disclosure and coordination among regulators—have set the stage for further progress. Next steps should include measures to promote competition in product, service and labor markets, including through deregulation, liberalization, and an improved business environment.

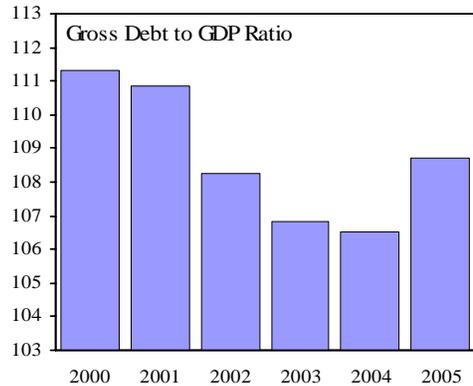
***The Financial Sector Assessment Program found that Italy's financial system is generally sound.*** The banking sector has proven resilient to slow growth, and stress tests revealed little vulnerability going forward. However, the FSAP identified issues related to loan classification standards and regulation of lending to related parties, and to relatively high operating costs. The mission also raised concerns about the Bank of Italy's governance structure and about potential conflicts of interest arising from the Bank's joint mandates for banking sector stability and competition, but these have substantially been addressed by amendments to the savings law approved in late-December.

## I. OVERVIEW AND KEY ISSUES

1. **Italy's medium-term prospects remain shackled by slow output and productivity growth, along with high debt and deficits.** Potential growth is estimated at only 1¼ percent annually, amid a steady deterioration in productivity and external competitiveness. The fiscal deficit exceeded 4 percent of GDP in 2005 and the public debt-to-GDP ratio—still among the highest in the world even after a decade of declines—is on the rise again, falling prey to high deficits and slow growth.



2. **Solving Italy's economic problems will demand determined policy implementation over a number of years.** With the primary surplus having fallen steadily since the late 1990s, significant fiscal consolidation will now be needed to ensure sustainability of the public debt, and the restoration of external competitiveness will also likely be a lengthy process. While the staff's message about the essential need for fiscal consolidation and broad-based structural reform is not new, the critical nature of these policies is accentuated by the heightened fiscal and competitiveness concerns (Box 1).



### **Box 1. Implementation of Fund Policy Advice**

**Fiscal consolidation:** Fund calls for significant fiscal consolidation have generally not been heeded. Between 2000 and 2003, the structural primary surplus net of one-off measures fell by about 2½ percent of GDP, with only a small part of this deterioration recovered in 2004–05.

**Pension reform:** The need for reforms to address the looming fiscal impact of population aging has been a long-standing theme of Article IV consultations. Important reforms have been implemented, most recently in August 2004, when Parliament approved the “framework law” on pension reform. The Fund had supported the reform, which is expected to have a significant impact on pension expenditure from 2008 onwards. A measure establishing a second pillar pension scheme for private sector workers was approved in November 2005, but its implementation has been delayed until 2008. The Fund has supported measures to promote private savings in the past.

**Competition, product market reform, and the business environment:** Successive Article IV consultations have repeatedly stressed the need for reforms in these areas. A “competitiveness decree” approved by Parliament in 2005 offers some enhancements along the encouraged lines, but progress has generally been slow. A long-pending reform of the bankruptcy law was approved by Parliament in December 2005, along with a reform of civil procedures.

**Labor market reforms:** Cross-country indicators of employment protection have registered marked improvement in recent years, as has labor market performance more broadly. In June 2003, the government approved a draft decree enacting the first part of a framework law on employment and the labor market, which the Fund had supported. The Fund has called for timely implementation of the second half of the law, but this remains to go forward.

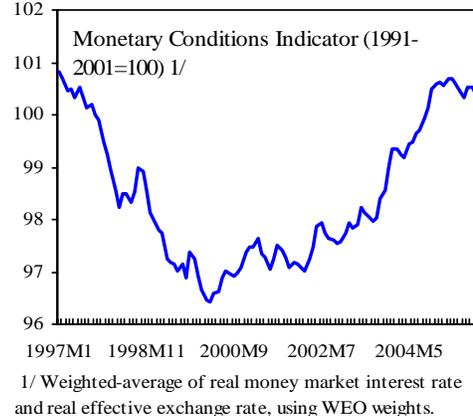
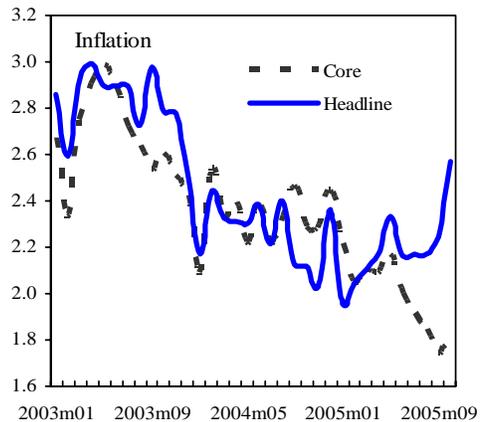
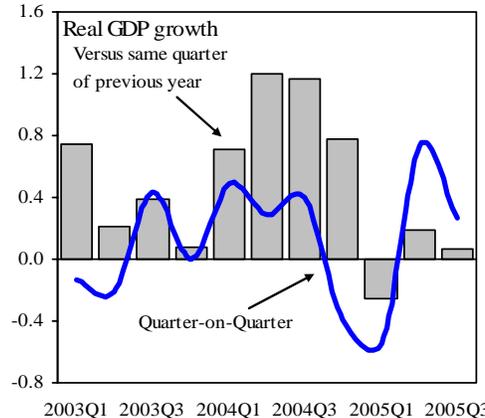
**Corporate governance:** Legislation that would strengthen corporate governance, the marketing and issuance of corporate bonds, and coordination among regulatory agencies—all of which have been supported by the Fund in previous consultations—was passed by Parliament in December 2005.

## II. BACKGROUND

3. **Despite the somber medium-term outlook, short-term prospects have brightened modestly, though uncertainties remain.** A strong and broadly-based rebound in 2005:Q2 (quarterly growth of 0.7 percent, seasonally-adjusted) had raised hopes that, following the technical recession at the turn of 2004–05, the long-awaited cyclical recovery was underway. A weaker-than-expected third quarter (0.3 percent, seasonally-adjusted), however, raised questions about the strength and durability of the recovery going forward. Nevertheless, the composition of demand—with consumption and exports performing relatively well, and most of the slowdown arising from a run-down of inventories—was more positive than the headline number.<sup>1</sup>

4. **Inflation has typically exceeded that of the euro area.** Sluggish domestic demand has helped contain inflationary pressures arising from high international oil prices, and core inflation has dropped below 2 percent, though it has consistently exceeded the euro-area average. The depreciating euro has led to some relaxation of monetary conditions since mid-year, although they remain very tight relative to the average since monetary union.

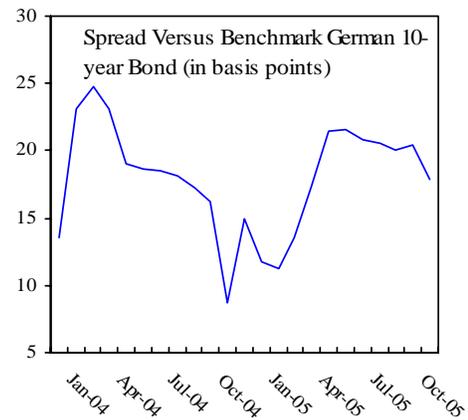
5. **The authorities have committed to reduce the fiscal deficit to below 3 percent of GDP by 2007 under the Excessive Deficit Procedure (EDP).** A combination of weaker-than-forecasted growth, disappointing asset sales, and Eurostat-mandated reclassifications put the original 2005 target of a 2.7 percent of GDP deficit out of reach.<sup>2</sup> A revised deficit target of 4.3 percent of GDP was



<sup>1</sup> The significant volatility of recent quarterly GDP data was difficult to explain, but the greater stability of 12-month growth rates led the authorities to suspect that it could in part be arising from problems with seasonal adjustment, particularly for exports.

<sup>2</sup> The reclassification of items also affected the deficits in earlier years: according to the revised accounts, the deficit exceeded the 3 percent of GDP ceiling in 2001, 2003 and 2004.

agreed under the EDP, but the achievement of even this less ambitious objective had proven challenging. Reflecting the high deficit and sizable shortfall in privatization receipts, the debt ratio increased in 2005, to over 108 percent of GDP. The deterioration in fiscal prospects led some agencies to downgrade the outlook for Italy's sovereign debt rating.<sup>3</sup> Spreads relative to German benchmarks have doubled since Fall 2004, but remain very small in absolute terms.



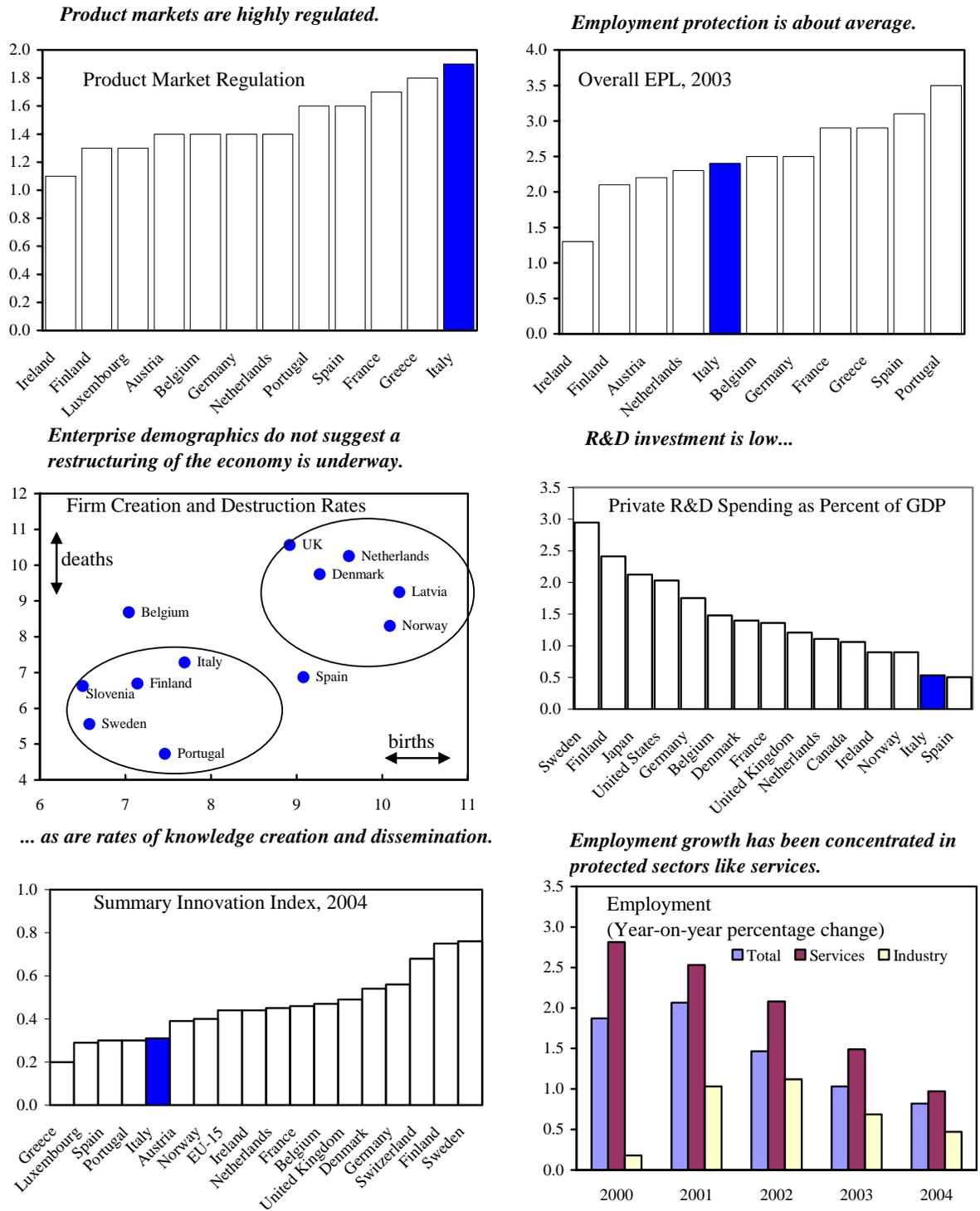
**6. Rigidities and inefficiencies throughout the economic structure are at the heart of Italy's difficulties.**

Despite some progress in recent years, measured product market regulation in Italy remains the strongest in the EU-15, distorting incentives and discouraging market entry and innovation (Figure 1). These rigidities have inhibited adjustment to the structural shifts that Italy has confronted due to increased competition from emerging market exports, perpetuating an economic structure dominated by a large number of small firms employing relatively low-tech, low value-added production techniques. Knowledge creation and dissemination (as measured for example by the European Commission's Summary Innovation Index) and private R&D investment are among the lowest in the EU-15, and rates of firm creation and destruction do not suggest an extensive transformation of the economy is underway.

**7. The advent of the common currency has brought these structural rigidities into sharper relief.** Normal adjustment mechanisms under monetary union have thus far failed to lead to an improvement in Italy's growth performance. In fact, since 2001 the external sector has sapped a cumulative 2 percentage points from output growth even as domestic demand weakened and foreign demand expanded sizably (Figure 2). The textbook gain in external competitiveness that should have resulted from Italy's relatively weak cyclical position has not materialized, and the loss in market share since the start of monetary union has persisted. The widening output gap—estimated by the staff at 2½ percent of GDP in 2005—has failed to exercise the necessary dampening effect on prices. In addition, although wage growth has slowed, it has significantly exceeded growth of labor productivity, which actually fell over 2001–04. Real unit labor cost growth has been markedly greater than that of France and especially Germany: since 1998 Italy's ULC-based REER has appreciated by a cumulative 18 percent, compared to depreciations in Germany and France. Consistent with the divergent experiences of the three largest euro area economies, staff analysis finds that slow productivity growth and domestic rigidities—and not euro strength—were the predominant

<sup>3</sup> Both Standard & Poor's and Fitch Ratings revised Italy's credit rating outlook from "stable" to "negative" in the summer of 2005.

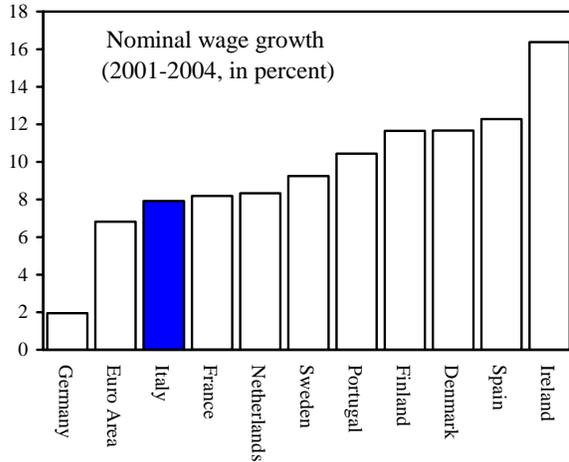
Figure 1. Italy: Market Rigidities



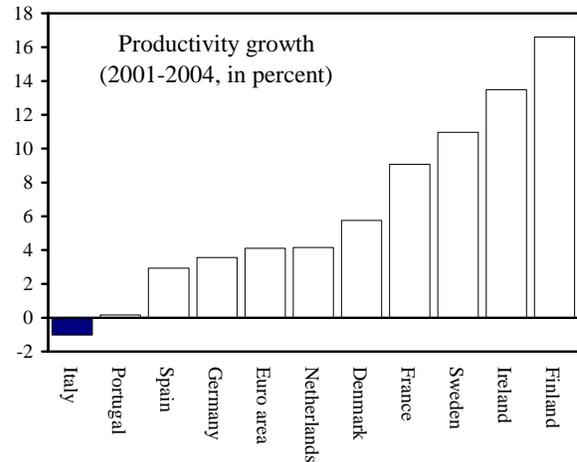
Source: OECD, Eurostat, ISTAT, and Fund staff calculations.

Figure 2. Italy: Competitiveness

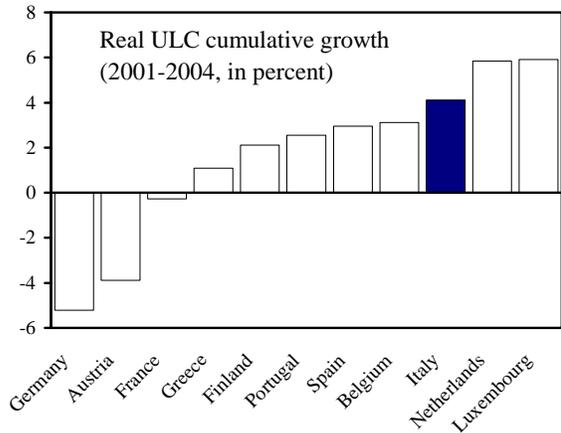
*Nominal wage growth has been moderate...*



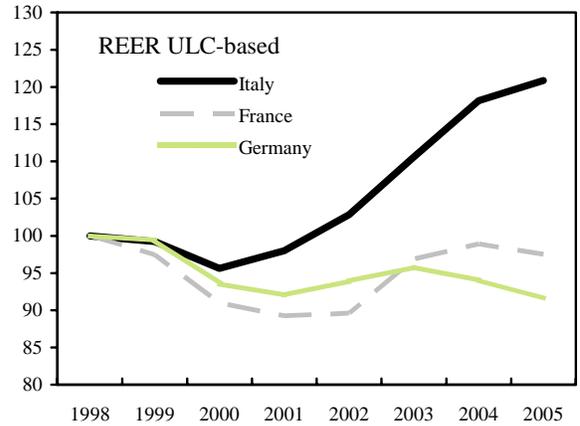
*...but productivity has fallen...*



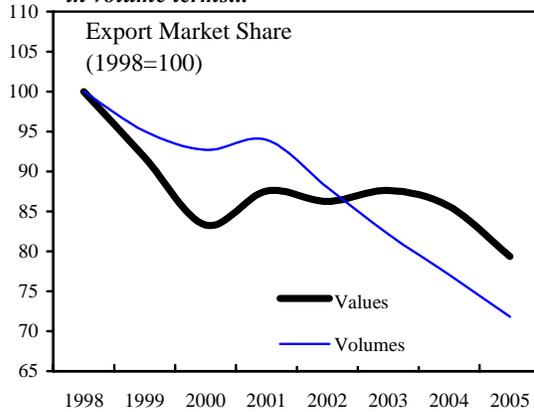
*...leading to strong unit labor cost growth...*



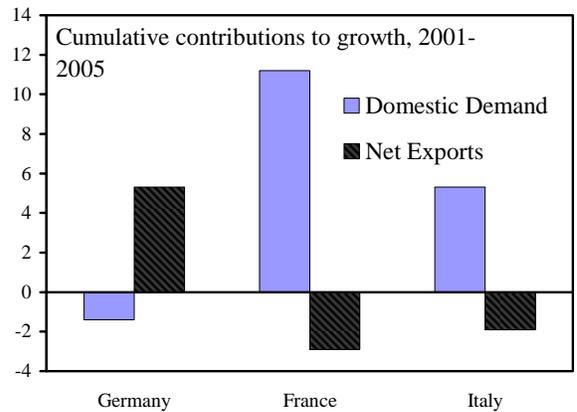
*... and a rapid real appreciation.*



*Export market share has fallen steadily, especially in volume terms...*



*... and the external sector has been a drain on growth*



Source: WEO, Eurostat, and staff calculations.

factors accounting for Italy's loss of competitiveness.<sup>4</sup> The fact that employment growth has been concentrated in sectors less exposed to external competition provides further evidence of competitive weaknesses.

### III. REPORT ON THE DISCUSSIONS

8. **Discussions were marked by general agreement on the main requirements to raise potential growth, but emphases differed on the proximate causes of Italy's problems, and a broad reform consensus has yet to emerge.** Staff and the authorities concurred on the need for durable expenditure-based fiscal adjustment and structural reforms in product, services, and labor markets. At the same time, however, there exists a widespread tendency to attribute Italy's problems to outside forces, be they euro strength or the pressures of globalization, or to an historical legacy, such as the small, family-owned firm structure and the traditional product specialization of Italian exports (centered on low-tech, low-value added sectors), along with a geographical orientation of exports toward slower-growing regions of the world. While staff did not dispute the importance of these factors, it stressed that Italy's economic problems were fundamentally homegrown, the consequence of rigidities and inefficiencies whose resolution demanded an integrated package of liberalizing reforms. The electoral calendar provided an opportunity to focus the national debate on the medium-term policies required to secure a more competitive Italy and, in meetings with the authorities and the economic representatives of the opposition, staff encouraged the main political coalitions to spell out the details of their economic programs. Some greater definition of electoral commitments has since emerged, but both coalitions are deeply fractured on key reform aspects, and may therefore be ill-equipped to overcome vested interests opposed to change.

#### A. Economic Outlook: A Timid Recovery Among Risks

9. **A mild cyclical recovery appears at hand.** The strength—and breadth across demand components—of the 2005:Q2 outturn had surprised most analysts, and was taken as evidence that cyclical conditions had turned the corner after four years of disappointing economic performance. At the time of the mission, most forecasters were therefore projecting annual output growth of about ¼ percent for 2005, although the weaker-than-expected third quarter outcome has since led most of them—and the staff—to reduce their estimates to barely above zero.

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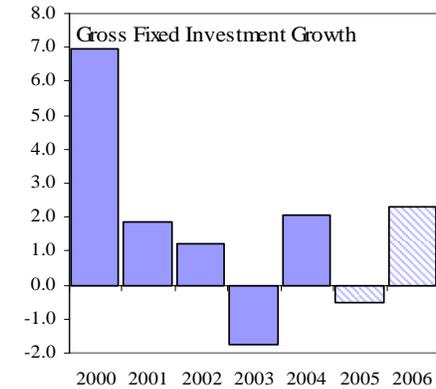
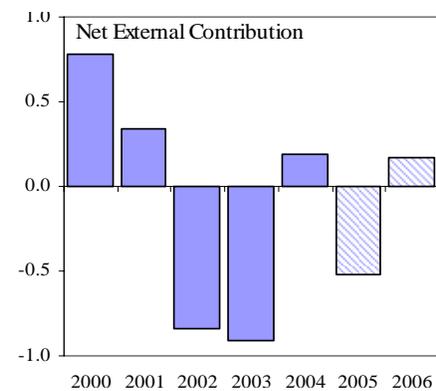
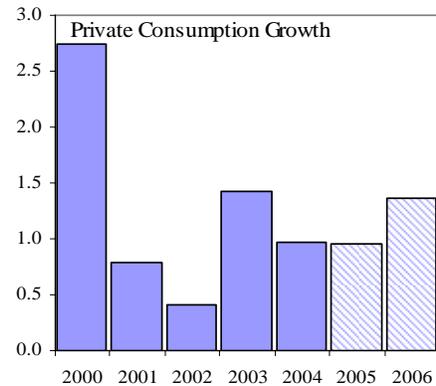
<sup>4</sup> A Selected Issues Paper examines factors accounting for Italy's trade performance, building on a cross-country study entitled "Explaining Differences in External Performance Among Large Euro Area Countries" (IMF Country Report 05/401), which serves as background to this consultation as well.

10. **For 2006, the staff forecasts growth of about 1½ percent, in line with the budget projection and slightly above the consensus forecast of 1.3 percent.** This would imply average quarterly growth of about 0.3 percent, equal to the 2005:Q3 outturn.

- Private consumption is expected to remain resilient, accelerating slightly relative to 2005 but staying within the narrow range posted since 2003.
- Strong global demand is projected to lead to an improved contribution from net exports, although gains in external competitiveness are not expected, as firms are likely to take advantage of somewhat slower ULC growth to restore margins. Indeed, Italy is projected to continue to lose market share.
- With indicators of business confidence rising and corporate balance sheets remaining healthy, the improved external contribution is forecast to encourage a recovery of productive investment, which has been languishing.

11. **Nascent cyclical recoveries have turned into false starts before, however, and downside risks are appreciable.** High international oil prices were seen as the main risk to growth, with several interlocutors also concerned about the impact of an increase in interest rates or possible renewed euro strength. Policy slippages could have a negative impact on confidence and on ratings agencies' evaluations, and the continued benign behavior of spreads cannot be assumed indefinitely in the absence of adjustment and reform.

12. **Inflation is expected to remain moderate.** As elsewhere in the euro area, there is little evidence that high oil prices have generated significant second-round effects on prices. The large flow of low-priced imports from emerging markets has helped contain inflation, even against the background of some euro weakness, but the already-noted positive inflation differential relative to the euro area despite Italy's sizable output gap raises concerns about possible underlying inflationary pressures.



## **B. Fiscal Policy in 2005–06: Living Up to EDP Commitments**

13. **The 2005 deficit target of 4.3 percent of GDP is likely to have been achieved, but margins were expected to be tight.** Despite unfavorable economic conditions, tax revenues had performed relatively well. There were, however, some indications that spending discipline had weakened later in the year. This, and the sizable shortfall in real estate sales (which are recorded as a deficit-reducing item under *ESA95*), had prompted a budget amendment in October that introduced additional spending cuts and revenue measures amounting to just over 0.1 percent of GDP. The authorities stressed that this underscored their commitment to achieving the target. Though not planned, the budget deficit would also be contained by delays in renewing some public sector wage contracts, which would push their fiscal impact into 2006. Achievement of the deficit target would entail a small improvement in the underlying fiscal position (about  $\frac{1}{4}$  percent of GDP as measured by the change in the cyclically-adjusted primary balance net of one-off measures). Nevertheless, current primary spending was projected to rise by about 0.7 percent of GDP in 2005, testimony to the considerable spending momentum in the public finances.

14. **The authorities have repeatedly strengthened the 2006 budget with a view to securing the EDP deficit target of 3.8 percent of GDP.** The package of measures included in the original draft 2006 budget, discussed early in the mission, fell far short of what was needed to achieve the EDP target, due also to inflated assumptions about likely real estate asset sales. The authorities agreed that the budget needed to be strengthened and—in a series of amendments during October-December—have done so in various ways (new measures, tighter expenditure control mechanisms, and the channeling of all asset sale proceeds to deficit reduction). The final 2006 budget contains measures that are officially estimated to yield about 1.9 percent of GDP, more than would be needed to compensate for the expiration of one-off measures and for some new spending initiatives, and to achieve the EDP deficit target. Indeed, the authorities now project the 2006 deficit at 3.5 percent of GDP. Such an outturn would also be consistent with the scale of improvement in the structural balance net of one-offs committed to under the EDP.

15. **Underlying expenditure dynamics underpin staff concerns about achievement of the 3.8 percent of GDP deficit target in 2006.** In particular, with no fundamental spending reforms, staff is less sanguine about the following items:

- The budget envisions deep cuts in central government current spending, but without changes in underlying determinants these will be difficult to enforce and sustain, especially on the heels of the within-year spending cuts already implemented in 2004 and 2005. Such mid-year cuts have typically resulted in spending rebounds in subsequent years.
- The budget assumes rigorous expenditure control at the local level, in particular for health care. Success in curbing health care costs was elusive in previous years, and according to available data only mixed progress was made in 2005.

- The budget calls for deep cuts in current and capital transfers to some state enterprises, notably the state highway agency (ANAS) and the railways, but without meaningful corporate restructuring these could prove unrealistic and generate off-budget liabilities for the government.
- In addition, the final budget raised revenue estimates—in some cases excessively, in the staff’s view.<sup>5</sup>

In light of these factors, the staff’s current central forecast is of a deficit of 4.0 percent of GDP in 2006. However, fiscal uncertainties are such as to readily encompass a range of deficit outcomes between 3¾ percent and 4¼ percent of GDP—depending also on the details of the outcome for 2005, which will be assessed in a supplement to this Staff Report.

Italy: Budget and Staff Projections (in percent of GDP)					
	2004	2005		2006	
	Est.	Budget	Proj.	Budget	Staff
Overall Balance	-3.2	-2.7	-4.3	-3.5	-4.0
Structural Balance <sup>1/</sup>	-2.6	-1.6	-3.2	-2.5	-3.0
net of all one-off measures	-4.0	-2.1	-3.8	-2.8	-3.3

Sources: Ministry of Finance and Fund staff estimates.

<sup>1/</sup> Based on staff estimates of the output gap.

16. **The authorities believed the risks highlighted by staff were contained and manageable.** First, they noted that revenue forecasts in the original budget were conservative. More fundamentally, they believed the expenditure risks highlighted by the mission were overstated. The authorities pointed to refinements they were introducing to the 2005 nominal cap on spending growth, allowing for greater differentiation across spending categories to enhance expenditure control. They also stressed that a number of initiatives had been implemented that would help contain the growth of health care costs, including the introduction of a national health card (*tessera sanitaria*) to improve controls and reduce fraud, and new mechanisms that would increase accountability among local governments for health spending overruns; since then, sanctions for such overruns have been strengthened, as well. They likewise felt there was limited risk associated with the cut in transfers to state enterprises, as these enterprises would have no option but to adjust their spending accordingly. Furthermore, there was some upside to the cuts in transfers, as they could provide impetus to a number of potential asset sales that were not incorporated in budget projections. In reiterating their commitment to the EDP target, the authorities noted that, as in the past, corrective measures could be introduced over the course of 2006, should they prove necessary.<sup>6</sup> Finally, the authorities were also investigating more effective ways to

<sup>5</sup> In particular, staff expects a shortfall in the yield of the so-called *concordato*, a tax assessment and settlement procedure covering both pending tax liabilities (2003-04) and those for future years (2006-08), which is partly one-off in nature. Yields from past similar schemes fell short of expectations.

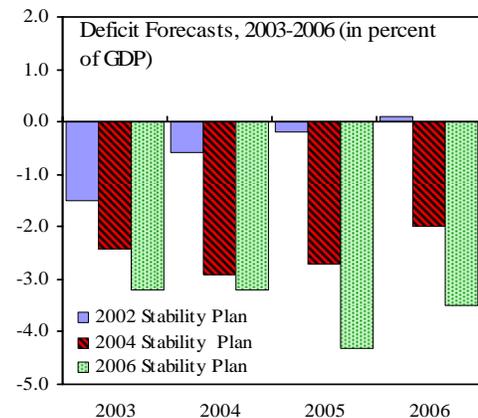
<sup>6</sup> In February 2006, the European Commission is to adopt a recommendation as to whether “effective action” has been taken to resolve Italy’s excessive deficit.

mobilize the state's considerable asset holdings to reduce the public debt, although details were not available at the time of writing.

### C. The Agenda for a More Competitive Italy

#### Fiscal Policy

17. **It was recognized that Italy's large public debt was an important constraint on potential growth, generating uncertainty about the future course of fiscal policy and diverting resources from more productive uses.** Thus, while reducing the deficit to below 3 percent of GDP by 2007 would be difficult, it was acknowledged that this was only the first step in the process of fiscal consolidation. The mission noted in particular that despite a series of important pension reforms over the last decade, bringing the deficit down to the Maastricht ceiling—or even the 1.5 percent of GDP envisioned for 2009 in the latest Stability Program update (December 2005)—would be insufficient to ensure the sustainability of the fiscal accounts, in light of pressures that will arise from population aging (Box 2). Staff simulations show that even assuming some improvement in labor productivity growth and the employment ratio in the coming years, rising aging-related expenditure would lead to explosive debt dynamics in the longer term. By contrast, under an adjustment scenario that envisages declines in the structural deficit of  $\frac{3}{4}$  percent of GDP annually to achieve overall balance by the end of the next legislature in 2010 (with constant non-aging-related spending thereafter), the debt ratio would gradually decline and then stabilize at about 50 percent of GDP in the long term. Staff noted that a commitment to achieve overall balance had once been a regular feature of SGP updates, but the decision to tolerate—rather than correct for—persistent shortfalls in budget performance had pushed this beyond the horizon of recent programs. This remains true of the latest Stability Program update, although within it the authorities do reiterate their general intention to achieve medium-term balance. The authorities assured the mission they would implement the once-every-decade adjustment in pension replacement rates in response to changes in life expectancy by end-2005, as mandated under the 1995 pension reform, but this has not yet occurred.



## Box 2. Fiscal Sustainability

The staff's **baseline scenario** assumes current policies are maintained through 2010. Thereafter, revenue and non age-related spending remain constant as percentages of GDP. Age-related (health and pension) expenditure reflects recent demographic projections and the pension reforms introduced since the mid-1990s. The baseline also assumes increases in labor productivity growth (to 1¼ percent annually, above the rate achieved over the last few years) and in the employment ratio (by 5 percentage points). Together, these result in long-run annual real GDP growth of ¾ percent. These assumptions are less optimistic than those underlying official projections, which assume annual productivity growth of 1¾ percent and a cumulative increase in the employment ratio of more than 10 percentage points. The baseline assumption on health care spending (as per the authorities' "national scenario") links age-adjusted per capita consumption of health services to growth of GDP per capita. Given recent health care spending trends, this may be optimistic. In the 2005 update of their Stability Program, the authorities used alternative methodologies (death-related costs, etc.) that yield more favorable estimates for Italy. The EC's Ageing Working Group recommends using a variety of scenarios to project health care costs, including one that links health spending to the growth of GDP per worker, which is more pessimistic than the staff's scenario.

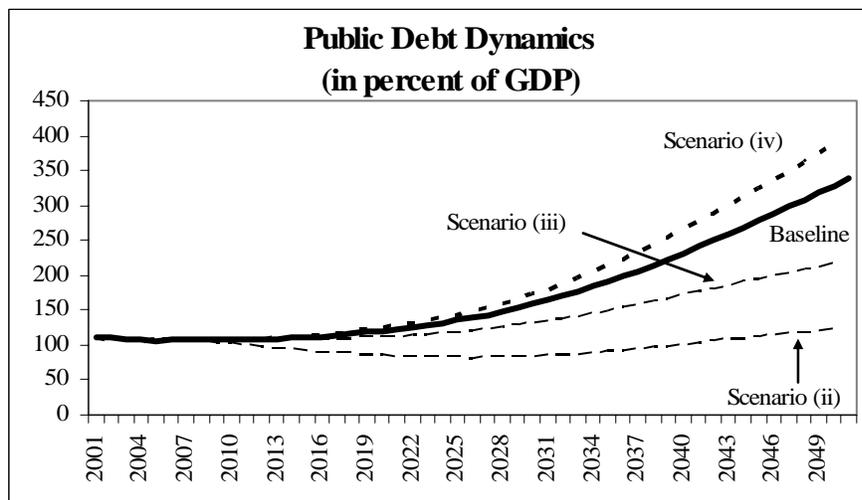
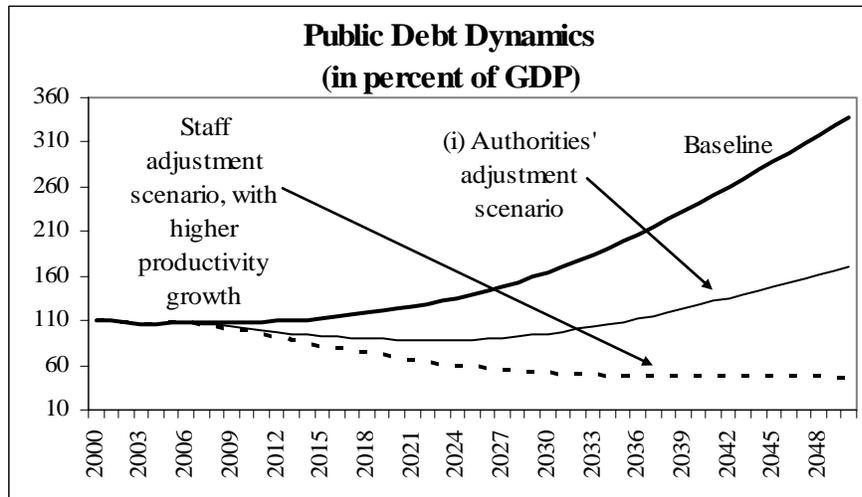
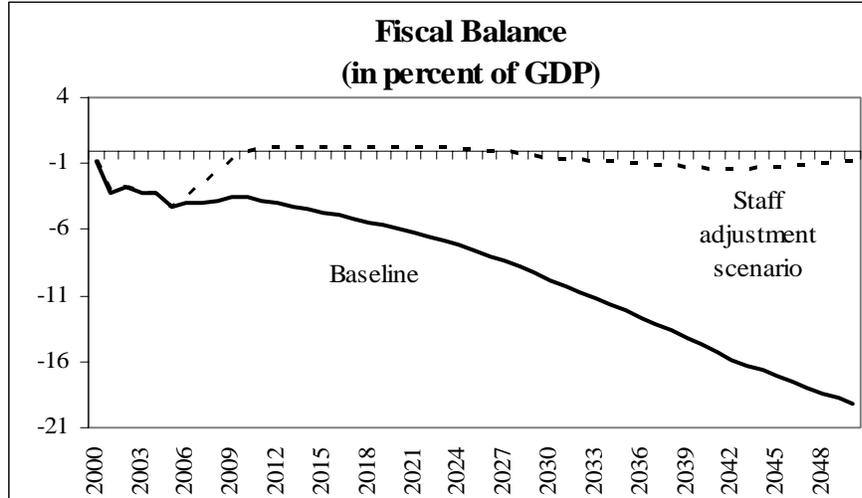
Under the baseline, the fiscal deficit would decline marginally over the next few years, but would rise thereafter, due to increased aging-related spending and, later, interest payments. The debt ratio would exceed 300 percent of GDP in 2050 (see Table 5).

The staff's **adjustment scenario** features annual structural adjustment of 0.7 percent of GDP in 2007–10 through spending cuts, leading to overall structural balance by the end of the decade. In addition, assuming current and future reforms, productivity growth rises by ¼ percentage point relative to the baseline, starting from 2011. Under this scenario, savings on the interest bill finance the increases in aging-related spending, with the debt-to-GDP ratio falling to around 50 percent by 2030 and then stabilizing.

**Stress test scenarios**, relative to the baseline, include: (i) implementation of the adjustment strategy detailed in the authorities' Stability Program update, whereby the overall fiscal deficit is reduced to 1½ percent of GDP by 2009; (ii) that same fiscal adjustment path, but with higher productivity growth than in the baseline (matching that in the staff's adjustment scenario); (iii) a more optimistic productivity growth scenario based on the authorities' assumptions, but with current fiscal policies; and (iv) failure to implement scheduled adjustments in pension replacement rates in line with life expectancy developments. Each of these scenarios yields a sizable increase in the debt ratio in the long run.

These results underscore the dual importance of reforms to increase potential growth and early action to address fiscal problems.

### Box 2. Fiscal Sustainability (concluded)



18. **The authorities agreed that budget consolidation needed to be based on expenditure containment, particularly given the trend growth of spending since the late 1990s.** Over the last several years, primary current spending had risen at an average annual rate of 2 percent in real terms, and Italy had largely squandered the fiscal dividend associated with euro participation. While the nominal cap on expenditure growth was seen to have played a useful restraining role in 2005, staff argued that achieving the required declines in spending would demand a better-targeted approach, focused on expenditure reduction within a medium-term budget framework. Cuts in subsidies to firms, rationalization of public employment, further steps to control health care costs, and reforms to enhance the efficiency of public procurement were likely sources of savings. The authorities noted that the planned nationwide implementation of SIOPE—an integrated data management system to track cash outlays at various levels of government—would provide a powerful tool for monitoring spending and facilitating budgeting.<sup>7</sup>

19. **The ongoing devolution of functions from the central government will remain a source of risk in the absence of a properly-designed system of fiscal federalism.** Although a High Commission on fiscal federalism had completed its mandate and issued a report containing options for tax assignments, tax sharing and equalization mechanisms, no major changes were planned ahead of the elections.<sup>8</sup> Meanwhile, the internal stability pact governing local government fiscal policies was again changed in the 2006 budget, negatively affecting the predictability of the framework and its ownership by local authorities. Staff observed that fiscal federalism arrangements will remain incomplete until increased spending responsibilities are paired with mechanisms allowing local governments to raise their own taxes and creating incentives for them to be fiscally responsible.

### **Structural Reforms**

20. **The mission and its interlocutors agreed on both the nature of Italy’s economic malaise and the broad outlines of the reform agenda.** Clearly, protracted slow productivity growth was at the heart of Italy’s poor economic performance, and sustained implementation of a suite of reforms to stimulate greater competition and facilitate entry across domestic markets was essential to accelerate potential growth. While the electoral climate was not conducive to making substantial progress on these fronts in the coming months, the authorities concurred that a number of reforms then before Parliament needed to be approved to set the stage for further progress, and this goal was subsequently achieved.

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<sup>7</sup> See the update of the Fiscal Transparency Report on Standards and Codes (ROSC).

<sup>8</sup> At the same time, a constitutional reform assigning exclusive jurisdiction over health, education, and local police to the regions secured parliamentary approval in early November.

21. **In line with commitments under the reformed Lisbon agenda, a medium-term national action plan had been submitted that touched on many of these topics.**<sup>9</sup> The plan groups priority initiatives into five broad areas: (i) liberalization of individual and enterprise activity; (ii) research and development; (iii) human capital; (iv) infrastructure; and (v) environment. The mission welcomed the report as a useful contribution to the debate, and suggested that the authorities emphasize the low-cost, high-benefit initiatives in the document—such as liberalization and the implementation of the EU services directive— ahead of other items (e.g., in research and infrastructure) that would involve high budgetary costs and more limited returns.

22. **Italy’s poor showing on indicators of product market regulation suggests there is substantial scope to eliminate barriers discouraging market entry and innovation.**

As a result of these barriers, cumulative cost increases for services in Italy have outstripped those in France and Germany, despite Italy’s lower productivity growth.

	Cumulative Cost Increases for Services, 2001-04 (in percent)			
	Financial Services	Insurance Services	Professional Services	Total
Italy	34.5	28.8	10.0	8.7
France	6.4	11.2	n/a	5.3
Germany	20.0	8.7	n/a	4.4

Source: Eurostat

- A host of rules inhibit **competition in the professional services**, including by barring nonprofessionals from performing nontechnical services, establishing minimum tariffs for certain activities, and prohibiting advertising. Closed associations (*ordini*) constitute formidable barriers to entry to professions that remain largely impregnable, as most professional services fall outside antitrust jurisdiction. There was some sympathy for the staff’s call to eliminate these restrictions, though associations and minimum fees were still viewed as necessary to ensure quality and protect consumers. No major initiatives were afoot; indeed, earlier planned reforms to the role of notaries had been scrapped. The issue is nevertheless present in the electoral debate.
- In **retail trade**, too, competition-inhibiting restrictions abound, with particular protection afforded to certain sectors (e.g., pharmacies). Competencies for retail trade have largely been devolved to lower levels of government, but staff called for the central government to proactively use its remaining responsibilities to promote competition.
- Despite considerable divestment, the **state still holds controlling shares in many enterprises**, some of which play a dominant role in key Italian markets (notably energy and transport), and most local utilities remain public. In this regard, while the authorities plan to abandon their “golden shares” in some of these enterprises (which have come under increasing scrutiny from the EU), they intend to replace them with “poison pill” arrangements that are also aimed at discouraging take-over bids. Staff noted that the continued public presence in some key sectors of the economy reduced

<sup>9</sup> *Piano Nazionale per l’Innovazione, la Crescita e l’Occupazione*, October 2005.

incentives to resist cost pressures and innovate, as pointed out by the OECD.<sup>10</sup> The authorities asserted the importance of keeping strategic industries in national hands, and noted that similar defensive instruments are used in other industrial countries. They nevertheless planned to continue divestment efforts.

- While the Antitrust Authority is proactive and well-regarded, **regulatory authorities** in certain key sectors play an insufficient role in promoting competition. Staff advocated enhanced powers for such authorities, and expressed concern about political influence in nomination procedures, as well as the possible impact of plans to terminate their financing from the budget. Government officials noted, however, that the latter initiative would be phased in gradually, and sought merely to reduce reliance on budgetary resources—to be offset by greater contributions from regulated industries—rather than weaken the capacity of the supervisory entities.
- In the **financial system**, as revealed also by the FSAP, greater market contestability—including importantly by foreign contenders—would make the sector more dynamic, yielding significant efficiency gains. Along with measures to increase the size and role of capital markets, it would also likely help reorient a predominantly relationship-based system that tended to favor incumbents over new entrants. On the whole, the authorities thought staff overstated the benefits of a foreign presence which in any case already existed (see ¶27), though they agreed on the desirability of increased competition and efficiency.

23. **Cross-country indicators point to a need to improve the business environment, and the authorities were confident that progress was in the offing.** Data collected by the World Bank and other international bodies suggest significant problems in this area, including slow legal processes and substantial bureaucratic requirements, though the authorities expressed reservations about applying cross-country data. They noted that an overhaul of the bankruptcy law, designed to simplify procedures and provide debtors with a fresh start, as well as a reform of civil procedures to accelerate legal processes, were in the final stages of legislative approval; the measures were passed by Parliament in

Italy--Business Environment		
	Italy	OECD avg.
Cost of Starting a Business (in pct per capita GDP)	15.7	6.8
Rigidity of Employment Index <sup>1/</sup>	57.0	36.1
Legal Framework to Facilitate Lending <sup>2/</sup>	3.0	6.3
Time Needed to Enforce Contracts (days)	1390	19.5
Cost of Foreclosing a Business (pct of estate value)	22.0	7.4

Source: World Bank (2005) *Doing Business Indicators*.

<sup>1/</sup> An overall measure that captures hiring and firing costs, plus rigidity of hours worked. Higher numbers indicate a more rigid environment.

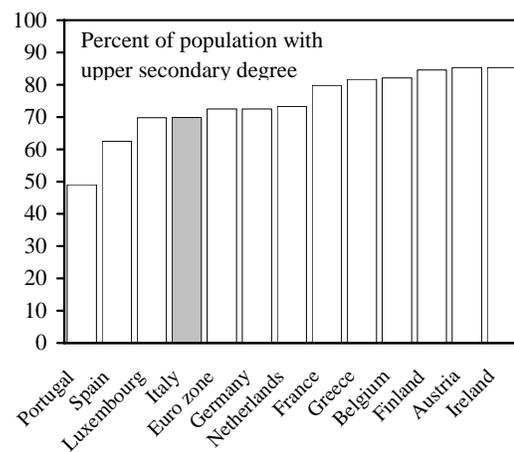
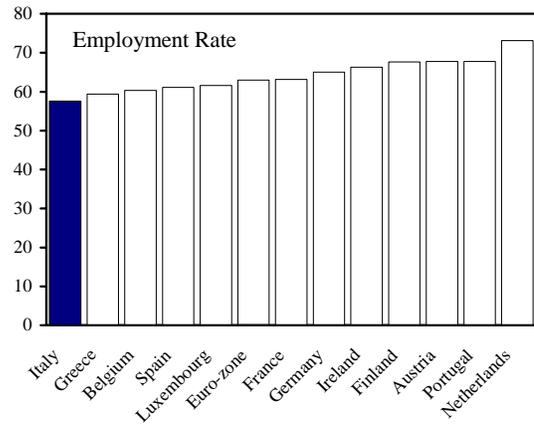
<sup>2/</sup> Measures how well collateral and bankruptcy laws facilitate lending. Higher numbers denote a more supportive environment for granting credit.

<sup>10</sup> OECD (2005) *Economic Survey: Italy*.

December 2005. Staff work illustrates the importance of differences in institutional quality, alongside product market regulation and tax rates, in explaining national and regional growth rates in the EU.<sup>11</sup>

**24. Recent reforms have brought Italy’s level of employment protection close to the advanced economy average, but a more fundamental reform of labor market institutions is only in its initial stages.**

Historically, strong employment protection legislation has substituted for an adequate social safety net, benefiting insiders but resulting in low participation rates, considerable employment precariousness for outsiders, and disincentives to mobility and risk-taking. The authorities noted that recent reforms had enhanced the system of unemployment compensation, in particular by extending the period over which benefits could be collected. The mission stressed that—in line with the so-called Biagi reform package—this needed to be complemented by a broader overhaul of the employment-related social safety net and further liberalization of employment protection legislation. Despite recent reforms, EPL remains relatively stringent, contributing to still-low employment rates. Labor union representatives, however, argued that reducing employment protection would not lead to the creation of high value-added job openings in profitable firms in the absence of a substantial increase in funding for education and worker training, especially as Italy continued to fall short of the EU average in many measures of human capital.



**25. The authorities observed that new forms of contracting had contributed to employment growth.** They pointed in particular to the beneficial impact of recent reforms to promote the use of part-time contracts and temporary agencies (“staff leasing”). They recognized, however, that recent work by the statistical agency suggested that as much as three quarters of the rise in employment registered since the start of 2003 had come from increases in the working age population—likely arising from the regularization of immigrants already in Italy—rather than from growth in the employment rate, a point

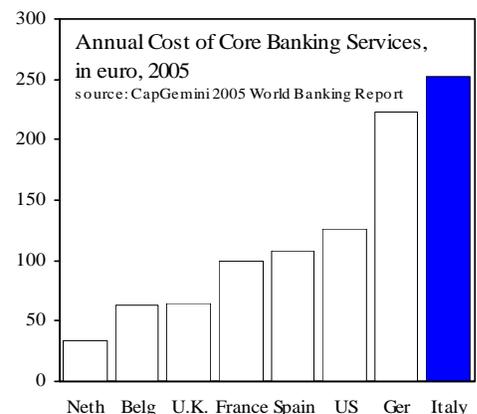
<sup>11</sup> See Selected Issues paper.

stressed by the trade unions.<sup>12</sup> The authorities noted that steps had been taken to link regional databases of job openings, helping to create a more transparent and efficient national labor market. They saw this as an important step to reduce the substantial regional disparities in unemployment rates. Staff's long-standing call for greater regional wage variation in line with productivity differences—which would address the same end—continued to meet with resistance, however.

#### D. Financial Sector

26. **The 2005 Financial Sector Assessment Program found that Italy's financial system was generally sound.** The banking sector has proven resilient to slow growth, and stress tests indicate little vulnerability to unfavorable macroeconomic shocks (Box 3). Nevertheless, the FSAP found a number of specific issues within the banking system that merited attention, including relatively lenient loan classification standards that complicated the assessment of banks' financial health, and insufficient regulation of lending to related parties. On the former issue, the Bank of Italy is undertaking measures to align the definition of impaired loans with the standard 90-day past due criterion. On the second issue, broad guidelines on connected lending have recently been approved by an interministerial committee, paving the way for the Bank of Italy to issue more detailed regulations on the matter. Stress tests results suggested some vulnerability to liquidity risk, but the authorities noted that liquidity indicators were broadly in line with those of other European countries. Finally, the revelations concerning financial improprieties in the context of recent takeover attempts, which came after the bulk of the FSAP work was conducted, indicate a need for greater vigilance in enforcing the overall strong supervisory framework.

27. **Turning to efficiency considerations, views differed on the extent to which market contestability was a concern.** A number of indicators suggest that overall competition in the banking sector is similar to that in other large European economies. However, the price of core banking services remains high and efficiency gains from the common currency have been small (Box 4).<sup>13</sup> In addition, European Commission surveys reveal a higher level of dissatisfaction with the quality of banking services than elsewhere in Europe.<sup>14</sup> The Bank of Italy cautioned

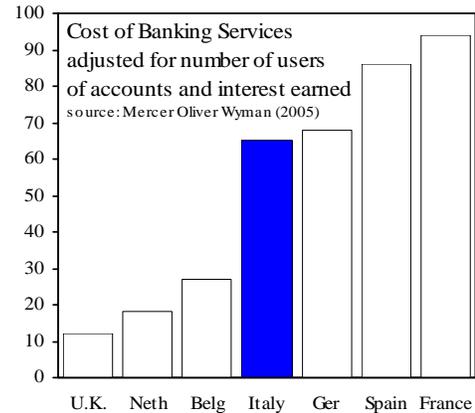


<sup>12</sup> To the extent these immigrants were already employed in Italy, their regularization would lead to some understatement of productivity growth since 2003, although the underlying analysis of productivity developments would not be affected.

<sup>13</sup> See the Selected Issues paper.

<sup>14</sup> European Commission (2004) *Public Opinion in Europe: Financial Services Report B*.

that attention needed to be paid to individual country circumstances when evaluating cross-country indicators. For example, high fees and commissions should be weighed against the relatively large number of interest-bearing and joint accounts in Italy. It also noted that the share of the system owned by foreign entities was already comparatively high (albeit consisting only of minority positions).



### Box 3. FSAP: Specific Issues

While the financial system is generally sound, a number of specific issues emerged from the FSAP that deserve attention:

- Market contestability in banking is limited and foreign entry has proven difficult. Further consolidation, including with the participation of strong foreign partners, would help enhance competition and efficiency; this would facilitate lower pricing of banking services.
- Italian banks exhibit structurally higher nonperforming loans compared to other leading European countries, despite more lenient loan classification standards. The authorities should accelerate the convergence to the standard 90-day past due criterion, which would provide more meaningful information on banks' financial health. The Bank of Italy is undertaking measures to move to a 180-day (and ultimately to the more standard 90-day) past due criterion.
- The limited regulation of lending to related parties creates uncertainty about the extent of connected lending in the banking sector. The staff supports current plans for enhancing regulation to permit a careful monitoring of this issue.
- Liquidity buffers in the banking sector have decreased and stress tests revealed some vulnerability to liquidity risk.

The FSAP also identified several issues related to the Bank of Italy's governance that are addressed in the main text.

#### **Box 4. Competition in the Banking Sector**

In addition to more traditional indicators of market structure, four main approaches can be used to assess the degree of competition in the banking industry (see the Selected Issues paper for details): (i) indicators of competition based on profitability, including measures of the differential between price and marginal cost (Lerner indices); (ii) measures of banks' revenue elasticity to input prices (Panzer-Rosse indices); (iii) price (net interest margin) indicators; and (iv) indicators based on costs of services and estimates of switching costs.

Using these four approaches, the selected issues paper finds that:

- **Competition in the Italian banking sector has intensified in loan and deposit markets in recent years, and banks do not seem to face markedly less competition than in other large European countries.** Although concentration at the national level has increased with the presence of 83 bank groups, the sharp rise in the number of branches since 1990 has contributed to greater competition in provincial and regional markets. The recent evolution and composition of bank profits also suggest some intensification of competition in the banking industry in the 1980s and 1990s, with some leveling-off in more recent years. Cross-country indicators—based on interest and profit margins as well as on indicators of revenue elasticity—suggest the existence of monopolistic competition in Italy, and find the degree of competition among banks is not dissimilar to that in comparable euro area countries.
- **Competition is not yet reflected in the pricing of core services.** According to one international survey, the average price of basic banking services (adjusted for local consumption patterns) appears to be among the highest in Europe.<sup>15</sup> Adjusting for joint-ownership of current accounts and the higher implied average balances, another study<sup>16</sup> found that the average price of holding a current account in Italy is still some 23 percent higher than the unweighted average for the EU countries surveyed. In addition, the authorities are concerned that high switching costs hamper competition and an investigation is being conducted by the Bank of Italy in cooperation with the anti-trust authority.

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<sup>15</sup> CapGemini et al. (2005) *World Retail Banking Report*.

<sup>16</sup> Mercer, Oliver & Wyman (2005) *Indagine Sul Pricing Dei Servizi Bancari in Europa*.

28. **There was also a divergence of views on the extent to which institutional arrangements were a barrier to greater banking competition.** Controversy over the conduct of the Bank of Italy in responding to two cross-border bank takeover bids—culminating in the resignation of the Bank’s governor—had revived public debate on potential conflicts among the central bank’s mandates to maintain financial system stability, enforce antitrust laws, and promote efficiency and competitiveness (though the cases in question did not themselves raise antitrust issues).<sup>17</sup> Representatives of the Bank argued that there was no inherent conflict among its mandates, noting that other central banks—notably, the US Federal Reserve—were also jointly entrusted with responsibility for competition and stability (although in the US oversight of competition was shared with the Department of Justice and the Office of the Comptroller of the Currency, with the Fed’s role limited to mergers and acquisitions and activities of bank holding companies). With recent controversies so eroding confidence in institutional arrangements and affecting perceptions of the contestability of the banking system, staff argued that consideration could usefully be given to shifting responsibility for competition to another authority. In mid-December the government amended the savings law in this direction, giving the Bank of Italy and the antitrust authority joint responsibility for bank mergers and acquisitions and transferring responsibility for other anticompetitive behavior fully to the antitrust authority.

29. **The savings law includes several essential changes to the Bank of Italy’s governance.** The law caps the governor’s lifetime mandate and seeks to increase transparency in the Bank’s decision-making process, such as through the submission of semiannual reports to Parliament and the Government. The Governing Council of the ECB issued a favorable review of the reforms, but recommended additional enhancements, including extending the fixed term of office to all members of the Bank of Italy’s directorate and increasing collegiality in its decision-making. It also stressed that central bank independence should be fully safeguarded in the planned transfer of the Bank’s ownership to the public sector (it is currently majority-owned by private sector banks). The government subsequently introduced amendments to the law to reflect the ECB recommendations, limiting a governor’s tenure to a maximum of two six-year terms, changing procedures for his nomination and dismissal, and instituting collegiality in decision-making.<sup>18</sup> It also shelved the planned ownership transfer for three years.

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<sup>17</sup> In early December, the EU Commission initiated proceedings against Italy for possible infringement of single market provisions on the free flow of capital and the right of establishment.

<sup>18</sup> On December 23, the ECB issued a favorable opinion on these amendments, as well as on the transfer of responsibility for banking competition oversight to the antitrust authority. The ECB noted the need for clear rules to resolve cases where proposed mergers are supported by the central bank on stability grounds but are opposed by the antitrust authority because of their effect on competition.

30. **The savings law also contains provisions that could enhance the role of non-bank financing in Italy, helping to increase financial sector efficiency and reorient the relationship-based system.** The law—a long-pending response to earlier corporate scandals—includes advances in corporate governance, in the marketing and issuance of corporate bonds, and in coordination among regulatory agencies.

31. **Amid conflicting pressures, a major reform to encourage private pension savings has been effectively delayed until 2008.** The reform, which allows workers to redirect their firm-based severance payment fund contributions toward privately-managed retirement schemes, had long been delayed by concerns over both its fiscal costs (as the government was expected to compensate firms for the loss of low-cost financing they would suffer from the diversion of severance fund contributions) and the extent to which the provisions established a level playing field among prospective private pension plan providers. The measure was passed in late November, but will take effect only in 2008, and further modifications are possible before then. The Italian household sector is marked by both high housing wealth and low debt, and the creation of more flexible financial instruments and products to help them meet their savings and investment needs, including for retirement, could bring significant benefits. It was also recognized that increased private pension saving was essential over the medium term in light of the impact that recent public pension reforms would have on benefits going forward. Staff analysis of fiscal multipliers in an intertemporal setting suggests that the household sector is in fact likely to smooth the future impact of pension reforms through greater asset accumulation.<sup>19</sup> A large number of self-employed workers remain without private pension coverage, and the authorities noted that future reforms would be needed to encourage retirement savings among this population.

#### **E. Fiscal Transparency Issues: Despite Progress, Far to Go**

32. **Staff has repeatedly pointed to the opacity of Italy's budget presentation.** Problems were particularly acute in 2005, when some “non-current policy” items (notably, real estate sales) were initially included in the trend deficit (*tendenziale*), necessitating a subsequent amendment to make the *tendenziale* conform to its definition, and the adoption of complementary measures to substitute for the asset sales. In addition, key budget documents are available only with a considerable delay, and up-to-date financial data on some important state enterprises are not widely disseminated. The authorities recognized the shortcomings of the present system, but argued that in many cases problems had more to do with the timely availability of data than with transparency *per se*. They noted, as well, that joint work by the Ministry of Economy, the Bank of Italy, and the statistical authority had narrowed the historically large unexplained gaps between the cash and accrual deficits, reducing one long-standing transparency concern. Against this background, and in light of repeated fiscal slippages, staff saw a need for improved fiscal governance mechanisms, including by establishing an entity to provide an independent analysis of fiscal developments, building on

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<sup>19</sup> See the Selected Issues paper.

the work performed by the Court of Auditors (*Corte dei Conti*) and other bodies. The authorities were reluctant to create yet another independent authority, noting also issues of democratic accountability, but saw scope for enhancing the powers of the *Corte dei Conti*. Staff considered this a potentially promising avenue, provided the Court's mandate was explicitly extended to include regular *ex ante* scrutiny of the budget process and developments (and not solely *ex post* auditing of outturns) and its staffing strengthened in line with its new duties.

33. **Recent initiatives to promote the use of Public-Private Partnerships (PPPs) in infrastructure investment could increase the efficiency of public spending.** The mission emphasized, however, that care needs to be taken to ensure transparency in the recording of these operations and associated contingent liabilities, including in budget documents. PPPs—which are still relatively underdeveloped in Italy—should be implemented only when they would result in higher spending efficiency and a balanced allocation of risks, and not to evade budgetary restrictions.<sup>20</sup>

#### F. Other Issues

34. **The authorities expressed their commitment to reducing barriers to international trade through a multilateral approach.** Italian textile firms had been severely affected by the elimination of export quotas under the Multi-Fiber Agreement, and the authorities welcomed accords that would provide additional breathing space for domestic firms to adjust to the new rules. They noted that losses to Italian firms from counterfeiting were sizable.

35. **Official development assistance remains low, but was projected to rise in 2005.** The authorities estimated that ODA could reach 0.3 percent of GNI in 2005, about double the 2004 ratio. Italy has committed to “make every effort” to reach a level of 0.5 percent of GNI for ODA in 2010, as an intermediate objective toward the medium- to long-term goal of 0.7 percent of GNI.

#### IV. STAFF APPRAISAL

36. **Past policy failings have left Italy in a difficult position.** Repeated fiscal slippages, and the practice of allowing one-off measures to substitute for fundamental reforms, have produced a deficit now appreciably above the 3 percent of GDP ceiling under the SGP, inhibiting a rapid reduction in the massive public debt, which is in fact on the rise again. In addition, while important labor market reforms have facilitated a significant increase in employment in recent years, a failure to liberalize product and services markets with the same vigor has contributed to economic stagnation and perpetuated a rigid productive structure. As a result, Italy is increasingly unable to compete in a world where its long-

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<sup>20</sup> These points are further developed in a Selected Issues paper prepared for the consultation.

standing advantage in relatively low-tech products has been eroded both by the rise of emerging market economies and by steady increases in domestic costs. The improving short-term outlook, with growth expected to rise to about 1½ percent in 2006, cannot obscure the serious medium-term challenges Italy faces. Early, decisive progress toward the resolution of these challenges must be the key economic priority of the next government.

37. **There is no alternative to reform.** Italy may continue to resist change, with insiders defending the dwindling economic rents they accrue from current levels of protection, while excessive deficits and spending overruns continue to perpetuate policy uncertainty. The likely impact of such policies—until they eventually prove unsustainable—is a continuation of the recent period of slow growth, fading competitiveness, and growing debt. The only economically viable option is to embark on broad-based structural reforms and medium-term fiscal consolidation aimed at creating a more robust, flexible, and dynamic economy. Such a transformation will be neither easy nor rapid, but holds out the prospect of faster potential growth and an economy better able to prosper in a globalized world. Reforms must start from a recognition that Italy’s economic problems are fundamentally “made in Italy,” and that their resolution can only be found there as well.

38. **Having succeeded in passing various long-pending structural reforms before the end of the legislative session, the government will now need to ensure observance of its fiscal commitments.** The measures approved in December are an important “down payment” on needed further reforms. The overhaul of the bankruptcy code will bring welcome improvements to the present antiquated law. New and accelerated civil procedures should also promote efficiency and entrepreneurial activity. The savings law—a long-overdue response to corporate scandals—contains advances in corporate governance, in the marketing and issuance of corporate bonds, and in coordination among regulatory agencies, and introduces changes in their respective responsibilities. It also contains important initiatives to improve the Bank of Italy’s governance and increase its accountability, which was not commensurate with its appropriately high degree of autonomy (which must, of course, continue to be fully safeguarded). In the period leading up to the election, the authorities now need to ensure that the fiscal targets agreed under the Excessive Deficit Procedure are secured, without recourse to one-off measures.

39. **Recent initiatives by the government have demonstrated its commitment to the agreed fiscal targets.** The package of expenditure cuts and revenue measures for 2005 gives reasonable confidence that the deficit target of 4.3 percent of GDP was achieved, although with tight margins. The 2006 budget has also been appreciably strengthened since its initial presentation. More generally, the fact that the 2006 budget is based on a realistic macroeconomic scenario and calls for adjustment mainly via expenditure containment rather than tax increases or significant one-off measures is welcome.

40. **Nevertheless, underlying expenditure dynamics stand to compromise achievement of this year’s EDP deficit target of 3.8 percent of GDP.** Deep cuts in spending at the central and local government levels could prove difficult to implement, especially for health care. Reductions in transfers to state enterprises will be unsustainable

absent credible corporate restructuring. Against this background, firm execution of spending and careful monitoring of outcomes will be of the essence, and recent steps to strengthen expenditure control are welcome. The nationwide rollout of SIOPE should also contribute meaningfully to expenditure monitoring, and should continue to be fully supported. Finally, if developments were to indicate slippages from the target, corrective measures should be taken in a timely manner, notwithstanding the electoral calendar.

41. **Looking beyond the elections, the next government must make an unequivocal commitment to reforms that enhance competition, reduce price mark-ups, and promote freedom of choice for consumers.** The main focus should be on product and services markets, complementing existing labor market reforms. In the professions, the array of rules that inhibit competition should be eliminated. Rapid implementation of the EU services directive, when finalized, would also stimulate competition and efficiency. 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, a move away from instruments such as “golden shares” and “poison pills,” and enhanced powers for the antitrust and sectoral authorities are also called for. Reforms to improve the business environment would contribute to faster growth, as well. Many of these reforms have low budgetary costs, and can be pursued regardless of the tight fiscal position. Product market reforms that increase domestic competition can also help shield the impact of continued wage moderation—which will be essential to restore competitiveness—on workers’ real incomes.

42. **Despite commendable progress in labor markets, there is scope for further reforms to raise Italy’s very low employment rate.** Past reforms to reduce employment protection and introduce new, more flexible forms of contracting have supported employment growth. Recent initiatives to improve the unemployment compensation system are a positive development. These should be seen as the first step toward a more thorough overhaul of the system, offering better and properly conditional unemployment support in concert with a further relaxation of employment protection legislation. Such reforms can facilitate the movement of labor to more productive uses, allowing the economy to respond more fluidly to the structural shifts it confronts. Furthermore, greater variation of wages in line with productivity differences remains critical to redress competitiveness losses in the short term, while more fundamental reforms take hold. Progress in enhancing human capital is needed, as well.

43. **Restoring the sustainability of the fiscal accounts is also necessary.** The targeted reduction of the deficit to below 3 percent of GDP by 2007 is insufficient to ensure sustainability of the public debt, especially in light of pressures that will arise from population aging. Repeated fiscal slippages over the last several years have led to the abandonment of the commitment to achieve overall fiscal balance within the period covered by Stability Program updates. This objective should be reasserted through the establishment of a path of medium-term deficit reduction sufficient to achieve overall balance by 2010, before the end of the next legislature. To be credible, such an adjustment should be centered

on expenditure containment, especially since the steady rise of primary current spending lies at the heart of Italy's current fiscal fragility. Reversing this trend will require an ambitious and targeted approach to expenditure rationalization within a medium-term budget framework. It will also require the adjustment of pension replacement rates every decade in line with developments in life expectancy, as mandated under the 1995 reform. Current delays in doing so are therefore of concern.

44. **Italy's budget presentation falls well short of international best practices for transparency and is in urgent need of improvement.** Recent work by the statistical authority, the Bank of Italy, and the Ministry of Economy to narrow the gap between the cash and accrual deficits has reduced an important element of uncertainty, and reconciliation efforts should continue. However, the use of a non-transparent *tendenziale* as the budget baseline means that fiscal planning gets off to a murky start. Moreover, the timeliness of information is unsatisfactory, with key details of underlying budgetary plans available only with a lag and up-to-date information on the financial position of some important state enterprises unavailable. Given the depth of the country's fiscal challenges, the authorities should seek an institutional mechanism able to provide regular, independent evaluations of budget proposals and trends at the behest of Parliament, whether via a new entity or a reinforcement of existing institutions.

45. **A competitive financial sector is also critical to support a more vibrant economy.** The FSAP reports Italy's financial system to be generally sound, although it also points to some structural weaknesses that constrain the system's role in promoting growth, including limited market contestability (notably for foreign contenders); high operational costs, fees and commissions; undersized corporate bond and equity markets; and a relationship-based orientation that favors incumbents. The authorities have taken steps to address some of the specific issues that emerged from the FSAP, and should move promptly on the others.

46. **Institutional reforms to assign banking competition issues to the antitrust authority address concerns about the potential conflict between stability and competition in the previous arrangement.** Preparatory efforts to transfer expertise and resources to the antitrust authority will be essential, however. It will also be important that its high level of independence be maintained, and that the division of responsibility between it and the Bank of Italy be established along clear lines with distinct accountability. The envisaged changes to the Bank of Italy's governance structure, in line with the recommendations of the ECB, are welcome.

47. **The authorities should resist pressures for increased trade protection, particularly for textiles, apparel and footwear.** Italy's commitment to raise its relatively low ODA is welcome.

48. **Economic statistics have remained broadly adequate for surveillance.** As noted above, however, there is a glaring need to improve the transparency and timeliness of fiscal data and documentation.

49. It is proposed that the next Article IV consultation take place on the standard 12-month cycle.

Table 1. Selected Economic and Social Indicators

	2001	2002	2003	2004	2005 1/	2006 1/
<b>Real economy (change in percent)</b>						
Real GDP	1.8	0.4	0.3	1.2	0.1	1.5
Total domestic demand	1.4	1.2	1.2	1.0	0.7	1.3
CPI (average)	2.3	2.6	2.8	2.3	2.3	2.3
Unemployment rate (in percent)	9.5	9.0	8.7	8.5	8.1	7.8
Gross national saving (in percent of GDP)	19.6	19.2	18.1	18.9	18.5	19.2
Gross domestic investment (in percent of GDP)	19.7	20.0	19.5	19.8	20.4	21.1
<b>Public finance (in percent of GDP)</b>						
General government balance	-3.2	-2.7	-3.2	-3.2	-4.3	-4.0
General government debt	110.9	108.3	106.8	106.5	108.7	108.4
<b>Money and credit (end of year, percent change)</b>						
Private sector credit 2/	7.0	6.2	7.0	5.9	8.7	...
National contribution to euro area M3 3/	6.0	8.1	6.7	8.1	8.5	...
<b>Interest rates (in percent)</b>						
6-month interbank rate 4/	4.3	3.3	2.3	2.1	2.2	...
Government bond rate, 10-year 5/	5.2	5.0	4.2	4.3	3.7	...
<b>Balance of payments (in percent of GDP, unless otherwise noted)</b>						
Trade balance	1.4	1.1	0.8	0.7	-0.3	-0.4
Current account balance	-0.1	-0.8	-1.3	-0.9	-1.9	-1.9
Exports of goods and services	24.8	24.8	28.4	32.3	33.2	32.8
Imports of goods and services	23.6	24.0	27.8	31.3	33.7	33.4
Volume growth (in percent): exports of goods and services	1.6	-3.2	-1.9	3.2	0.5	4.0
imports of goods and services	0.5	-0.5	1.3	2.5	2.3	3.4
Net imports of oil (in bln. of U.S. dollars)	11.9	12.4	14.8	19.1	26.3	29.8
Foreign Direct Investment (net, in percent of GDP)	-0.6	-0.2	0.5	-0.1	0.0	0.1
<b>Fund position (as of November 30, 2005)</b>						
Holdings of currency (percent of quota)					78.1	
Holdings of SDRs (percent of allocation)					21.9	
Quota (millions of SDRs)					7055.5	
<b>Exchange rates</b>						
Exchange rate regime	Member of EMU					
Euro per U.S. dollar (December 21, 2005)	0.85					
Nominal effective rate (2000=100) 5/	100.4	101.6	105.8	107.2	106.4	...
Real effective rate (2000=100) 5/ 6/	101.1	104.2	111.4	113.7	110.2	...
<b>Social indicators</b>						
GDP per capita, in U.S. dollars	2004	29,014				
Population density, inhabitants per square kilometer	2002	196.2				
Income distribution, ratio of income received by top relative to bottom quintiles	2001	5.1				
At-risk-of-poverty rate, persons (in percent)	2001	19.0				
Life expectancy (years at birth): males	2002	75.0				
females	2002	81.9				
Illiteracy, percent of persons aged 15 and above	2002	1.5				
Gender pay gap, share of female versus male pay, in percent	1995	81				
Automobiles per 1000 inhabitants	2000	572.4				
CO2 emissions, in metric tons per capita	2000	7.4				

Sources: Italian authorities; IMF, *International Financial Statistics*; World Bank, *World Development Indicators*; Bloomberg; Eurostat; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise noted.

2/ Twelve-month credit growth, adjusted for securitizations. Data for 2005 refer to April.

3/ Excludes currency in circulation held by non-bank private sector. 2005 data refers to July.

4/ Data for 2005 refer to October.

5/ Data for 2005 refer to November.

6/ Based on CPI.

Table 2. Italy: General Government Accounts, 2001-06  
(In percent of GDP)

	2001	2002	2003	2004	2005		2006	
					Staff	Auth.	Staff	Budget
Total revenues /1	45.7	45.3	46.0	45.2	44.8	44.8	44.6	44.9
Direct taxation	15.0	14.2	13.7	13.6	13.5	13.5	13.6	13.7
Indirect taxation	14.5	14.7	14.4	14.4	14.5	14.5	14.4	14.4
Social contributions	12.6	12.8	13.0	12.9	13.1	13.2	12.9	13.0
Other current revenues	3.3	3.2	3.1	3.3	3.3	3.3	3.3	3.3
Capital revenues	0.3	0.4	1.8	1.0	0.4	0.4	0.4	0.4
Total expenditures 1/	48.8	48.1	49.2	48.5	49.1	49.2	48.6	48.4
Current expenditures	44.5	44.2	44.7	44.3	44.8	44.9	44.4	44.4
Wages and salaries	10.8	10.8	11.1	11.0	11.1	11.2	11.1	11.1
Purchases of goods and services	7.7	7.7	7.8	7.6	7.8	7.8	7.6	7.4
Social transfers	16.6	17.0	17.3	17.3	17.5	17.5	17.6	17.7
Interest payments	6.5	5.8	5.3	5.1	5.0	5.0	4.8	4.8
Capital expenditures	4.4	3.9	4.5	4.1	4.3	4.2	4.1	4.0
<i>Of which</i> : asset sales	-0.2	-0.9	-0.2	-0.3	-0.2	-0.2	-0.1	-0.1
Overall balance	-3.2	-2.7	-3.2	-3.2	-4.3	-4.3	-4.0	-3.5
Primary balance	3.4	3.0	2.1	1.9	0.7	0.6	0.8	1.3
Memorandum items:								
Structural overall balance 2/	-3.8	-2.6	-2.6	-2.6	-3.2	-3.2	-3.0	-2.5
Net of all one-off measures	-4.6	-4.1	-4.6	-4.0	-3.8	-3.7	-3.3	-2.8
Structural primary balance 2/	2.8	3.1	2.7	2.4	1.7	1.8	1.8	2.3
Net of all one-off measures	2.0	1.6	0.6	1.0	1.2	1.3	1.5	2.0
Nominal GDP (in billions of euros)	1,219	1,261	1,301	1,351	1,386	1,384	1,442	1,435
Public Debt	1,351	1,365	1,389	1,440	1,507	1,502	1,563	1,550
Public debt	110.9	108.3	106.8	106.5	108.7	108.5	108.4	108.0
Real GDP growth (in percent)	1.8	0.4	0.3	1.2	0.1	0.0	1.5	1.5
One-off measures 3/	0.8	1.5	2.1	1.4	0.6	0.5	0.3	0.3

Sources: ISTAT; Ministry of Economy and Finance, and Fund staff calculations and estimates.

1/ For temporal consistency, the numbers do not include recent (deficit-neutral) updates made in the new Stability Program, in line with EU regulation 1500/2000.

2/ In percent of potential GDP, assumes staff's output gap.

3/ Staff estimates, unless otherwise indicated.

Table 3. Italy: Financial Soundness Indicators  
(In percent, unless otherwise noted)

	2001	2002	2003	2004	2005
Core Set					
Deposit-taking institutions					
Capital adequacy					
Regulatory capital to risk-weighted assets	10.4	11.2	11.4	11.6	11.6
Regulatory tier I capital to risk-weighted assets	7.8	8.2	8.5	8.5	8.8
Asset quality					
Nonperforming loans					
Share of total gross loans	6.7	6.5	6.6	6.5	6.3
Percentage change	-7.8	2.4	7.6		
Net of provisions, percent of capital	24.4	22.4	21.4		
Sectoral distribution of loans to total loans					
General government	5.8	5.3	4.7	4.5	4.4
Financial corporations	14.7	14.6	13.8	12.1	11.9
Nonfinancial corporations and sole proprietorships	59.3	59.0	59.6	59.5	59.2
Building and construction	6.8	6.9	7.2	7.4	7.3
Consumer households	20.2	21.0	21.9	23.9	24.5
Large exposures to capital	88.6	81.6	63.2	51.3	61.7
Earnings and profitability					
Return on assets	0.59	0.50	0.51	0.65	0.70
Return on equity	8.6	7.1	7.4	9.4	
Interest margin to gross income	52.3	56.6	55.9	55.9	...
Noninterest expenses to gross income	55.3	59.8	60.9	60.6	...
Liquidity					
Liquid assets to total assets (liquid asset ratio)	8.7	7.8	8.6	8.4	7.9
Liquid assets to short-term liabilities	21.8	17.3	16.9	16.7	18.3
Sensitivity to market risk					
Duration of assets	7M21D	8M18D	9M6D	9M29D	10M0D
Duration of liabilities	7M1D	8M4D	8M24D	9M14D	9M16D
Net open position in foreign exchange to capital	4.9	3.9	3.6	2.4	3.0
Encouraged Set					
Deposit-taking institutions					
Capital to assets	6.8	6.7	6.4	6.4	
Average risk weight (ratio of risk-weighted assets to assets)	0.66	0.60	0.57	0.55	
Geographical distribution of loans					
North	62.2	62.2	62.3	62.2	62.2
Center	24.1	24.1	24.0	23.5	23.4
South	13.7	13.6	13.7	14.3	14.4
Geographical distribution of nonperforming loans					
North	38.5	40.2	43.0	43.4	44.2
Center	26.7	28.0	26.5	26.5	26.0
South	34.7	31.9	30.5	30.2	29.9
Gross asset position in financial derivatives to capital	50.8	46.7	52.0	62.8	74.9
Gross liability position in financial derivatives to capital	37.0	44.8	45.0	58.1	73.1
Trading and fee income to gross income	32.7	32.0	32.7	33.9	36.0
Personnel expenses to noninterest expenses	63.4	63.9	64.8	65.7	66.7

Source: Bank of Italy, Eurostat, Fund staff calculations.

Table 3. Italy: Financial Soundness Indicators (continued)

(In percent, unless otherwise noted)

	2001	2002	2003	2004	2005
Spread between reference lending and deposit rates (CDs up to 6 months)					
Household lending (average for new loans)	3.3	3.0	2.9	2.2	
Corporate lending (average for new loans)	2.2	2.1	2.1	1.9	
Spread between highest and lowest interbank rate					
Customer deposits to total (noninterbank) loans	103.4	107.4	104.6	106.9	105.2
Foreign currency-denominated loans to total loans	5.5	4.2	3.7	2.9	2.1
Foreign currency-denominated liabilities to total liabilities	2.3	2.4	2.5	2.4	...
Net open position in equities to capital	11.5	2.5	2.5	3.1	...
Market liquidity					
Average bid-ask spread in the securities market	0.0	0.0	0.0	0.0	...
Average daily turnover ratio in the securities market	0.9	0.8	0.8	0.7	...
Nonbank financial institutions					
Assets to total financial system assets	36.6	34.6	33.7	32.2	...
Assets to GDP	90.0	85.4	86.9	83.6	...
Corporate sector					
Debt to GDP - Italy	77.0	80.2	85.1	...	...
Debt to GDP - euro area	...	...	...	...	...
Total debt to equity	87.7	102.2	106.4	98.8	...
Return on equity	4.4	2.4	4.9	...	...
Earnings to interest and principal expenses	271.6	242.0	300.7	...	...
Corporate net foreign exchange exposure to equity	-2.6	-2.2	...	...	...
Number of applications for protection from creditors	605	883	...	...	...
Household sector					
Household debt to GDP - Italy	22.9	24.3	26.0	28.1	...
Household debt to GDP - euro area	53.8	...	...	...	...
Household debt service and principal payments to income	1.9	1.8	1.7	1.7	...
Real estate markets					
Real estate prices (1990=100, deflated by CPI)					
Residential	104.6	114.6	124.1	131.9	...
Commercial	101.1	106.5	112.4	119.7	...
Residential real estate loans to total loans	10.3	12.0	13.8	15.7	...
Commercial real estate loans to total loans	6.8	6.9	7.2	7.4	...

Table 4. Italy: Selected Indicators of Vulnerability 1/  
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	
					Latest Est.	Date
<b>External indicators 1/</b>						
Exports (annual percentage change, in U.S. dollars)	1.6	3.2	18.0	18.2	4.7	
Imports (annual percentage change, in U.S. dollars)	-0.9	4.4	19.8	19.0	9.5	
Terms of trade (annual percentage change)	0.5	1.0	2.2	0.0	-2.3	
Current account balance (settlement basis)	-0.1	-0.8	-1.3	-0.9	-1.9	
Capital and financial account balance	-0.2	0.7	1.5	0.8	1.9	
<i>Of which</i> : Inward portfolio investment (debt securities, etc.)	2.7	2.8	4.1	3.5	...	
Inward foreign direct investment	1.4	1.2	1.1	1.0	...	
Other investment liabilities (net)	0.8	-0.6	2.5	1.4	...	
Official reserves (in U.S. dollars, billions, end-of-period) 2/	24.4	28.6	30.4	27.9	26.6	Nov
Contribution to euro area M3 (in percent of reserves) 3/	25.8	28.4	34.4	43.7	48.6	Oct
Central Bank foreign liabilities (in U.S. dollars, billions) 2/	2.2	3.1	0.5	0.9	0.6	Nov
Foreign assets of the financial sector (in U.S. dollars, billions)	152.6	224.5	317.0	389.5	...	
Foreign liabilities of the financial sector (in U.S. dollars, billions)	280.7	319.7	425.7	497.5	...	
Official reserves (ratio to average monthly imports) 2/	1.0	1.1	1.0	0.8	...	
Total external debt	80.9	90.7	94.0	93.1	...	
<i>Of which</i> : General government debt	35.0	42.0	44.5	44.8	...	
Total external debt to exports (ratio)	2.9	3.5	3.7	3.6	...	
External investment income payments to exports (in percent)	15.5	17.6	17.9	15.9	...	
Exchange rate (per U.S. dollars, period average)	1.12	1.06	0.89	0.81	0.85	Nov
<b>Financial market indicators</b>						
Public sector debt (Maastricht definition)	110.9	108.3	106.8	106.5	108.7	
3-month T-bill yield	4.1	3.3	2.2	2.1	2.2	Nov
3-month T-bill yield (real)	1.4	0.6	-0.6	-0.2	-0.4	Nov
Stock market index (year end)	75	58	66	78	85	Nov
Share prices of financial institutions (year end)	71	50	62	58	...	
Spread of 3-month T-bills with Germany (percentage points, period average)	0.4	0.3	0.2	0.1	0.0	Nov
<b>Financial sector risk indicators 4/</b>						
Foreign exchange loans (in billions of U.S. dollars)	45.7	43.9	49.1	44.5	...	
Share of foreign exchange loans in total lending (percent)	5.5	4.2	3.7	2.9	...	
Deposits in foreign exchange (in billions of U.S. dollars)	22.1	29.2	...	...	...	
Share of foreign deposits in total deposits (percent)	4.1	4.6	...	...	...	

Sources: Bank of Italy, *Economic Bulletin* and *Statistical Bulletin*; data provided by the authorities; IMF, *International Financial Statistics* and *Balance of Payments Statistics Yearbook*; and Fund staff estimates and projections.

1/ The interpretation of some indicators is affected by the launch of monetary union in 1999.

2/ Reserves and foreign liabilities refer to the Bank of Italy, both before and after EMU; excluding gold.

3/ Definition of M3 from 1999 onwards excludes currency held by the public.

4/ Data refer to banks, including cooperative and mutual banks.

Table 5: Italy Public Sector Debt Sustainability Framework, 2003-2050  
(In percent of GDP, unless otherwise indicated)

	Actual		Projections									
	2003	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050
<b>I. Baseline Projections</b>												
<b>Public sector debt</b>	106.8	106.5	108.7	108.4	108.2	108.0	108.4	108.7	123.3	164.6	242.0	339.9
Overall balance	-3.2	-3.2	-4.3	-4.0	-4.0	-3.8	-3.6	-3.5	-6.0	-9.9	-14.8	-19.4
Pension spending	14.2	14.3	14.4	14.5	14.6	14.7	14.5	14.4	15.4	16.9	17.8	17.3
Health care spending	6.2	6.5	6.7	6.7	6.7	6.7	6.7	6.7	7.1	7.6	8.0	8.3
<b>Key Macroeconomic and Fiscal Assumptions</b>												
Real GDP growth (in percent)	0.3	1.2	0.1	1.5	1.7	1.7	1.7	1.7	1.0	0.7	0.5	0.8
Real GDP per capita growth (in percent)	-0.3	0.3	-0.5	1.4	1.6	1.6	1.6	1.6	1.0	0.8	0.6	1.1
Labor productivity growth (in percent)	-0.8	0.4	-0.5	0.4	0.8	0.8	1.1	1.3	1.2	1.4	1.4	1.3
Employment rate (in percent)	57.5	57.5	58.2	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3
Average nominal interest rate on public debt (in percent)	5.1	5.0	4.8	4.5	4.5	4.5	4.6	4.7	5.1	5.1	5.1	5.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.1	2.3	2.2	2.0	2.2	2.3	2.4	2.6	3.0	3.0	3.0	3.0
<b>II. Authorities' adjustment effort 1/</b>												
<b>Public sector debt</b>	106.8	106.5	108.7	107.9	106.6	104.8	103.1	101.1	89.8	98.4	132.2	178.0
Overall balance	-3.2	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5	-1.3	-2.2	-4.5	-7.4	-9.4
Pension spending	14.2	14.3	14.4	14.5	14.6	14.7	14.5	14.4	15.4	16.9	17.8	17.3
Health care spending	6.2	6.5	6.7	6.7	6.7	6.7	6.7	6.7	7.1	7.6	8.0	8.3
<b>Key Macroeconomic and Fiscal Assumptions</b>												
Real GDP growth (in percent)	0.3	1.2	0.1	1.5	1.7	1.7	1.7	1.7	1.0	0.7	0.5	0.8
Real GDP per capita growth (in percent)	-0.3	0.3	-0.5	1.4	1.6	1.6	1.6	1.6	1.0	0.8	0.6	1.1
Labor productivity growth (in percent)	-0.8	0.4	-0.5	0.4	0.8	0.8	1.1	1.3	1.2	1.4	1.4	1.3
Employment rate (in percent)	57.5	57.5	58.2	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3
<b>III. Staff adjustment scenario</b>												
<b>Public sector debt</b>	106.8	106.5	108.7	107.9	106.4	104.1	101.5	98.3	69.6	53.2	51.1	50.7
Overall balance	-3.2	-3.2	-4.3	-3.5	-2.6	-1.6	-0.7	0.0	0.1	-0.7	-1.5	-1.1
Pension spending	14.2	14.3	14.4	14.5	14.6	14.7	14.5	14.4	15.1	16.2	16.9	16.1
Health care spending	6.2	6.5	6.7	6.7	6.7	6.7	6.7	6.7	7.1	7.6	8.0	8.3
<b>Key Macroeconomic and Fiscal Assumptions</b>												
Real GDP growth (in percent)	0.3	1.2	0.1	1.5	1.7	1.7	1.7	1.7	1.2	0.9	0.7	1.1
Real GDP per capita growth (in percent)	-0.3	0.3	-0.5	1.4	1.6	1.6	1.6	1.6	1.3	1.1	0.9	1.3
Labor productivity growth (in percent)	-0.8	0.4	-0.5	0.4	0.8	0.8	1.1	1.3	1.4	1.6	1.6	1.6
Employment rate (in percent)	57.5	57.5	58.2	58.5	58.7	59.0	59.2	59.5	61.5	61.7	63.1	63.3

Sources: ISTAT; Ministry of Economy and Finance, and Fund staff calculations and estimates.

1/ Assumes that the authorities meet the targeted decline in the overall deficit through 2009, but the macroeconomic framework is that underlying the (staff's) baseline.

**Italy: Fund Relations**  
(As of November 30, 2005)

I. **Membership Status:** Joined 3/27/47; Article VIII.

<b>II. General Resources Account:</b>	SDR Million	Percent Quota
Quota	7,055.50	100.00
Fund holdings of currency	5,512.50	78.13
Reserve position in Fund	1,543.01	21.87

<b>III. SDR Department:</b>	SDR Million	Percent Allocation
Net cumulative allocation	702.40	100.00
Holdings	152.95	21.77

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):**

	Forthcoming			
	2006	2007	2008	2009
Principal				
Charges/Interest	16.47	16.53	16.58	16.53
<b>Total</b>	<b>16.47</b>	<b>16.53</b>	<b>16.58</b>	<b>16.53</b>

VII. **Exchange Rate Arrangement:** Italy entered the final stage of European Economic and Monetary Union on January 1, 1999, at a rate of 1,936.27 Italian lire per 1 euro.

Italy maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Italy solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51). Those exchange restrictions are contained in the following legal instruments:

- Council Regulation (EC) No. 2488/2000 of 10 November 2000, as amended, maintaining a freeze of funds in respect of Mr. Slobadan Milosevic and people associated with him.
- Council Regulation (EC) No. 1763/2004 of 11 October 2004, as amended, imposing certain restrictive measures in support of effective implementation of the mandate of the International Criminal Tribunal for the Former Yugoslavia.

- Council Regulation (EC) No. 2580/2001 of 27 December 2001, as amended, on specific restrictive measures directed against certain persons and entities with a view to combating terrorism.
- Council Regulation (EC) No. 881/2002 of 27 May 2002, as amended, imposing certain restrictive measures directed against certain persons and entities associated with Osama bin Laden, the Taliban and the Al-Qaida network
- Council Regulation (EC) No. 1210/2003 of 7 July 2003, as amended, concerning certain specific restrictions on economic and financial relations with Iraq.
- Council Regulation (EC) No. 314/2004 of 19 February 2004, as amended, concerning certain restrictive measures in respect of Zimbabwe.
- Council Regulation (EC) No. 798/2004 of 26 April 2004, as amended, renewing the restrictive measures in respect of Burma/Myanmar.
- Council Regulation (EC) No. 872/2004 of 29 April 2004, as amended, concerning freezing of funds and economic resources of persons and entities associated with Liberia's former President Taylor.

VIII. **Article IV Consultations:** Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during October 27–November 10, 2004, and the staff report (Country Report No. 05/44, 02/10/05) was discussed on February 7, 2005.

IX. **ROSCs:**

<b>Standard Code Assessment</b>	<b>Date of Issuance</b>	<b>Country Report</b>
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234
FSAP	February, 2006 (expected)	n/a

### Italy: Statistical Information

Italy's economic database is comprehensive and of generally high quality. Italy has subscribed to the Special Data Dissemination Standard (SDDS) and has posted the metadata on the Dissemination Standards Bulletin Board (DSBB). Data are provided to the Fund in a comprehensive manner (see attached table). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements and timeliness and reporting standards of Eurostat and the European Central Bank (ECB), and has adopted the *European System of Accounts 1995 (ESA95)*.

*A Report on the Observance of Standards and Codes (ROSC)—Data Module* (Country Report No. 02/234, 10/18/02) found Italy's macroeconomic statistics to be of generally high quality, but also identified some shortcomings that hindered an accurate and timely analysis of economic and financial developments: (i) no statistical agency had the responsibility to compile and disseminate a comprehensive statement of government finances, and a persistent difference had emerged between the SGP-monitored fiscal deficit and the PSBR net of privatization receipts (discussed in detail in the 2004 Staff Report); (ii) source data and/or statistical techniques could be strengthened in several areas, most importantly, by raising response rates on the enterprise surveys used in the national accounts and producer price index, making price collection for the consumer price index more efficient, and improving the coverage of cross-border financial transactions; (iii) balance of payments and government finance statistics could be closer aligned with the internationally accepted methodological guidelines on concepts and definitions, scope, classification and sectorization, and/or valuation; and (iv) resources were under pressure in some parts of the National Institute of Statistics in the face of the statistical requirements of the European Union and the Euro area.

Recent steps to improve economic data include: the introduction in 2005 of the regional price indices by the National Institute of Statistics (Istat); the publication of quarterly data for the general government balance, expenditure, and revenue on an accruals basis (in line with *ESA95*) starting in October 2003; and more detailed labor survey, conducted by professional staff. Progress has also been made in reconciling the discrepancy between the cash-based net borrowing requirement and the accrual budget deficit, and working groups—consisting of representatives of the Bank of Italy, Ministry of Economy and Finance, and Istat—meet regularly to look at different aspects of the reconciliation. While some differences still exist between the two measures, these are now accounted for more comprehensively and speedily (see the 2005 Fiscal ROSC Update Report for details).

Notwithstanding these improvements, weaknesses remain in some areas. In the national accounts, inventory accumulation is derived as a residual and lumped together with the statistical discrepancy thus hampering the business cycle analysis. Furthermore, as highlighted by the fiscal transparency ROSC and the two follow-ups, the quality and timeliness of some fiscal data, particularly on expenditure by local governments, is still in need of improvement. Finally, the shift to chain-weighted indices for national accounts, initially scheduled for March 2005, was postponed until December.

**Italy: Table of Common Indicators Required for Surveillance**  
(As of December 30, 2005)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>7</sup>	Data Quality – Accuracy and reliability <sup>8</sup>
Exchange Rates	12/13/05	12/13/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	Nov 2005	Dec 2005	M	M	M		
Reserve/Base Money	Nov 2005	Nov 2005	M	M	M	O, O, LO, LO	O, O, O, O, LO
Broad Money	Nov 2005	Nov 2005	M	M	M		
Central Bank Balance Sheet	Nov 2005	Oct 2005	Q	Q	Q		
Consolidated Balance Sheet of the Banking System	Jun 2005	Oct 2005	Q	Q	Q		
Interest Rates <sup>2</sup>	12/13/05	12/13/05	D	D	D		
Consumer Price Index	Nov 2005	Nov 2005	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	Oct 2005	Dec 2005	M	M	M	LO, O, LO, O	LO, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	Oct 2005	Dec 2005	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	Nov 2005	Dec 2005	M	M	M		
External Current Account Balance	Sept 2005	Sept 2005	M	M	M	O, LO, LO, O	LO, O, LO, O, O
Exports and Imports of Goods and Services	Oct 2005	Dec 2005	M	M	M		
GDP/GNP	Q3 2005	Dec 2005	Q	Q	Q	O, O, O, O	LO, LO, O, O, O
Gross External Debt							

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

<sup>7</sup> Reflects the assessment provided in the data ROSC (published in October 2002, and based on the findings of the mission that took place during April 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

<sup>8</sup> Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND

ITALY

Staff Report for the 2005 Article IV Consultation

Supplementary Information

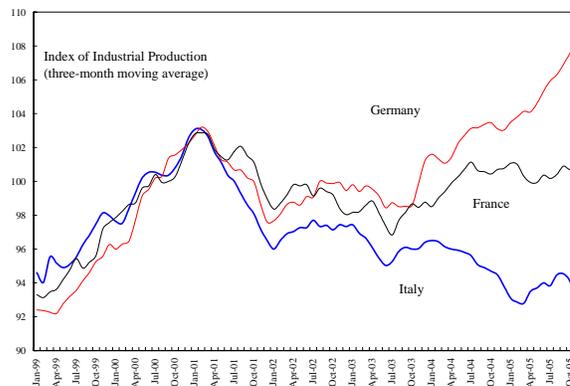
Prepared by the European Department

Approved by Michael Depler and Michael Hadjimichael

February 1, 2006

1. **This Supplement provides information that has become available since the issuance of the Staff Report for the 2005 Article IV Consultation.** The new information does not alter the thrust of the staff appraisal.

2. **Recent short-term macroeconomic indicators have been, on balance, disappointing.** Notably, industrial production rose by a much less-than-expected 0.1 percent in November (month-on-month), and the October outturn was revised downward. As a result, a number of forecasters have downgraded their growth estimates for 2005, and downside risks to the staff's 2005-06 forecast have risen. More positively, notwithstanding the weak industrial production data, the index of business confidence experienced its eighth consecutive monthly increase in January, reaching its highest level in nearly four years, and harmonized consumer price inflation declined further to 2.0 percent (year-on-year) in December, despite the rebound in oil prices.



3. **The authorities have introduced a number of steps to strengthen execution of the 2006 budget.** In particular, monitoring systems, enforcement mechanisms, and sanctions have been enhanced—including for health spending—and the role of the Court of Auditors in evaluating subnational governments' budget preparation and execution has been increased. These measures—reviewed in detail by staff with the authorities in meetings in January—go some way to addressing the staff's concerns about the risks posed by underlying expenditure dynamics to the 2006 EDP deficit target (3.8 percent of GDP). However, their effectiveness—in the absence of measures to address structural spending determinants and given a history of leniency vis-à-vis past non-

compliance with spending norms<sup>1</sup>—will depend on the willingness of the authorities to enforce them rigorously. The authorities have again emphasized such readiness to staff. In addition, preliminary data suggest a slightly stronger-than-expected revenue performance in 2005. On this basis, and assuming the downside risks to the growth forecast do not materialize, the staff has revised its central 2006 deficit forecast down marginally, to 3.9 percent of GDP, while maintaining the range of uncertainty (+/- ¼ percent of GDP) noted in the Staff Report (¶15).

4. **A first test of the new procedures will come at end-March 2006.** At that time, regions that have exceeded their health spending limits in 2005 are to be issued a formal Prime Ministerial warning requiring them to undertake corrective measures. Failure to comply would lead the region's healthcare administration to be put into a form of central government receivership (*commissariamento*). In addition, rates on some regional taxes would increase automatically with effect from end-May 2006. It will be of the essence that such steps—should they prove necessary—be undertaken in a timely and resolute manner.

5. **Implementation of the new savings law is progressing.** The anti-trust authority has moved quickly to exercise its mandate in the banking sector. Shortly after the new law came into effect, the authority opened an investigation into the costs of banking services. As noted in the Staff Report (¶27), fees and commissions are typically higher in Italy than in other large European countries. A revision of the Bank of Italy's statute is also underway to ensure its compliance with the provisions of the savings law.

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<sup>1</sup> Exemplified as well by the inclusion in the 2006 budget of a limited pardon for past breaches of budgetary procedures and norms. This pardon has come under strong criticism from the President of the Court of Auditors.

Table 1. Selected Economic and Social Indicators

	2001	2002	2003	2004	2005 1/	2006 1/
<b>Real economy (change in percent)</b>						
Real GDP	1.8	0.4	0.3	1.2	0.1	1.5
Total domestic demand	1.4	1.2	1.2	1.0	0.7	1.3
CPI (average)	2.3	2.6	2.8	2.3	2.3	2.3
Unemployment rate (in percent)	9.5	9.0	8.7	8.5	8.1	7.8
Gross national saving (in percent of GDP)	19.6	19.2	18.1	18.9	18.5	19.2
Gross domestic investment (in percent of GDP)	19.7	20.0	19.5	19.8	20.4	21.1
<b>Public finance (in percent of GDP)</b>						
General government balance	-3.2	-2.7	-3.2	-3.2	-4.3	-3.9
General government debt	110.9	108.3	106.8	106.5	108.7	108.3
<b>Money and credit (end of year, percent change)</b>						
Private sector credit 2/	7.0	6.2	7.0	5.9	8.8	...
National contribution to euro area M3 3/	6.0	8.1	6.7	8.1	8.7	...
<b>Interest rates (in percent)</b>						
6-month interbank rate 4/	4.3	3.3	2.3	2.1	2.5	...
Government bond rate, 10-year 5/	5.2	5.0	4.2	4.3	3.6	...
<b>Balance of payments (in percent of GDP, unless otherwise noted)</b>						
Trade balance	1.4	1.1	0.8	0.7	-0.3	-0.4
Current account balance	-0.1	-0.8	-1.3	-0.9	-1.9	-1.9
Exports of goods and services	24.8	24.8	28.4	32.3	33.2	32.8
Imports of goods and services	23.6	24.0	27.8	31.3	33.7	33.4
Volume growth (in percent): exports of goods and services	1.6	-3.2	-1.9	3.2	0.5	4.0
imports of goods and services	0.5	-0.5	1.3	2.5	2.3	3.4
Net imports of oil (in bln. of U.S. dollars)	11.9	12.4	14.8	19.1	26.3	29.8
Foreign Direct Investment (net, in percent of GDP)	-0.6	-0.2	0.5	-0.1	0.0	0.1
<b>Fund position (as of December 31, 2005)</b>						
Holdings of currency (percent of quota)					82.6	
Holdings of SDRs (percent of allocation)					22.8	
Quota (millions of SDRs)					7055.5	
<b>Exchange rates</b>						
Exchange rate regime	Member of EMU					
Euro per U.S. dollar (January 30, 2006)	0.85					
Nominal effective rate (2000=100) 4/	100.4	101.6	105.8	107.2	106.5	...
Real effective rate (2000=100) 4/ 6/	101.1	104.3	111.4	113.8	110.1	...
<b>Social indicators</b>						
GDP per capita, in U.S. dollars	2004	29,014				
Population density, inhabitants per square kilometer	2002	196.2				
Income distribution, ratio of income received by top relative to bottom quintiles	2001	5.1				
At-risk-of-poverty rate, persons (in percent)	2001	19.0				
Life expectancy (years at birth): males	2002	75.0				
females	2002	81.9				
Illiteracy, percent of persons aged 15 and above	2002	1.5				
Gender pay gap, share of female versus male pay, in percent	1995	81				
Automobiles per 1000 inhabitants	2000	572.4				
CO2 emissions, in metric tons per capita	2000	7.4				

Sources: Italian authorities; IMF, *International Financial Statistics*; World Bank, *World Development Indicators*; Bloomberg; Eurostat; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise noted.

2/ Twelve-month credit growth, adjusted for securitizations. Data for 2005 refer to July.

3/ Excludes currency in circulation held by non-bank private sector. 2005 data refers to October.

4/ Data for 2005 refer to November.

5/ Data for 2005 refer to December.

6/ Based on CPI.



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 06/13  
FOR IMMEDIATE RELEASE  
February 7, 2006

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2005 Article IV Consultation with Italy**

On February 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.<sup>1</sup>

### **Background**

A consolidation of the cyclical recovery that began in mid-2005 is expected this year, with growth rising from close to zero last year to about 1½ percent in 2006. Net exports and investment should benefit from sustained demand in partner countries, while consumption growth is forecast to remain within the narrow range witnessed in recent years. Despite high international energy prices, inflationary pressures should remain modest, at just over 2 percent in 2006. Despite the better cyclical outlook, medium-term trends remain troubling: potential growth is estimated at just 1¼ percent, as low productivity growth and high domestic costs have led to a steady erosion of competitiveness and export market share.

The 2005 fiscal deficit target of 4.3 percent of GDP is estimated to have been met, thanks in part to measures introduced by the authorities late last year, though current expenditure dynamics remained strong. For 2006, the authorities have committed to a deficit target of 3.5 percent of GDP. To this end, they strengthened the budget substantially in various steps. Sustaining the envisaged deep expenditure cuts will require strict implementation of the budget's enhanced control and sanction mechanisms.

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<sup>1</sup> 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.

Labor market reforms and wage moderation have led to a substantial increase in employment in recent years, although the employment ratio remains very low. In other areas, some key structural measures were approved in late 2005, including a long-overdue reform of the bankruptcy code, an updating of civil procedures, and a “savings law” that enhances corporate governance, disclosure, and coordination among regulators. Nevertheless, a number of cross-country indicators point to the presence of rigidities and inefficiencies in the economic environment that constrain Italy’s growth potential.

The 2005 Financial Sector Assessment Program (FSAP) found that Italy’s financial system is generally sound and well regulated. The banking sector has proven resilient to slow growth, and stress tests revealed little vulnerability going forward. However, the FSAP identified issues related to market contestability, loan classification standards, and lending to related parties, and noted that the cost of core bank services was relatively high. The mission also raised concerns about the Bank of Italy’s governance structure and about potential conflicts of interest arising from the Bank’s joint mandates for banking sector stability and competition, but these have substantially been addressed by reforms approved in late-December 2005.

### **Executive Board Assessment**

Executive Directors welcomed the expected consolidation of the recovery of the Italian economy that began in mid-2005 following several years of slow growth. Against this backdrop, Directors commended the authorities’ commitment to the agreed fiscal targets, as reflected in the additional measures taken to strengthen the 2006 budget. They also welcomed the recent progress in passing some long-standing structural reforms, including an overhaul of the bankruptcy code, new and accelerated civil procedures, and a savings law that strengthens corporate governance and coordination among regulatory agencies—all of which constitute important steps forward on needed reforms.

At the same time, Directors stressed that Italy faces difficult policy challenges going forward. Italy’s medium-term prospects are troubling, as slow productivity growth has significantly eroded its competitive position and export market share. In addition, pervasive rigidities and inefficiencies in the domestic economy are restraining growth more generally, with potential growth now estimated at just 1¼ percent annually. The large public debt also remains a drag on the economy. Against this background, Directors considered that Italy must undertake significant fiscal consolidation over the medium term to reduce the high public debt and fiscal deficit, while widening and deepening structural reforms. Directors believed that progress on both fronts will help the Italian economy adapt better to external challenges, and more generally, to better compete in an increasingly globalized world and in the context of the single currency.

Directors stressed that, in the present pre-electoral period, the economic policy priority is to ensure the credibility of the fiscal adjustment targets agreed to under the Excessive Deficit Procedure (EDP). In view of Italy’s recent history of missed fiscal targets, they viewed the recent steps taken to strengthen the 2006 budget as a welcome sign of the authorities’ commitment both to consolidation and to the EDP fiscal targets. While endorsing the budget’s reliance mainly on expenditure restraint, Directors emphasized the importance of cautious execution of spending plans, together with timely monitoring and strict implementation of the

strengthened control and sanction mechanisms. They welcomed the authorities' assurance that corrective measures will be implemented promptly if slippages emerge. Several Directors also emphasized that recourse to amnesties and one-off measures should be discontinued, in order to enhance the durability of fiscal adjustment. Directors noted that in the medium term—and in the absence of a reform of the fundamental determinants of spending—the underlying expenditure dynamics could put significant pressure on the budget.

Directors stressed the need for a strong commitment to a program of liberalization and deregulation going forward, based on reforms that will enhance competition, eliminate economic rents, and promote freedom of choice for consumers. With past reforms having prioritized labor markets, the main focus should be on liberalizing product and services markets. Directors recommended several measures: freeing professional services of the array of rules that inhibit competition, including via rapid implementation of the EU services directive, when finalized; using the central government's responsibilities over retail trade to promote consumer welfare through greater competition; further deregulating network sectors, with a reduction in the government's predominant interest in privatized firms; and enhancing the powers of the antitrust and sectoral authorities. Another key priority is to improve Italy's business environment, including by reducing bureaucratic burdens and accelerating legal processes. Directors welcomed the National Action Plan for Innovation, Growth, and Employment, and urged the authorities to implement it in a comprehensive and timely manner to make progress toward the Lisbon Agenda targets. Early implementation of a broad package of such reforms will be essential to create a more competitive Italy and boost medium-term performance.

Directors welcomed the strong growth of employment of recent years, which is largely attributable to past reforms that reduced employment protection and introduced new, flexible forms of contracting. Nonetheless, the employment rate remains very low, indicating a need for further action. While the recent initiatives to improve the unemployment compensation system are a positive development, Directors suggested that these be seen as the first steps toward a more thorough overhaul of the system that should aim to offer better and properly-conditional unemployment support along with more flexible labor legislation. Furthermore, greater variation of wages in line with productivity differences is critical to redress competitiveness losses in the short term, while more fundamental reforms take hold. Greater wage flexibility across regions could also help improve the high regional disparity in employment rates. Directors also encouraged the authorities to strengthen education and training.

Restoring the sustainability of the fiscal accounts will also be essential for stronger medium-term growth. While welcoming the authorities' commitment to reduce the fiscal deficit to below 3 percent of GDP in 2007, Directors cautioned that this will be insufficient to ensure the sustainability of the public debt, especially in light of the pressures that will arise from population aging. They therefore called on the authorities to commit to a path of medium-term deficit reduction sufficient to achieve overall balance by 2010, before the end of the next legislature. Directors stressed that, to be credible, such an adjustment will need an ambitious and targeted approach to expenditure containment, relating in particular to subsidies, public employment, and health care. As the steady rise of primary current spending underlies the country's fiscal fragility, several Directors underscored the importance of strengthening the primary balance. Directors also noted the contribution that sales of public assets could make to

reducing the public debt and enhancing economic efficiency. Directors urged that the adjustment of pension replacement rates—mandated to take place every decade in line with developments in life expectancy but delayed—now be effected promptly. Directors also stressed the importance of a properly designed system of fiscal federalism to maintain budget discipline in the presence of ongoing devolution.

Directors stressed the need to enhance the transparency of Italy's budget presentation, which falls short of international best practices. Directors commended the work that has helped to narrow the gap between the cash and accrual deficits. They called for following this up with efforts to increase the transparency of budget preparation; ensure the timely availability of key budget documents; and disseminate up-to-date financial data on key state enterprises. Directors supported the authorities' intention to strengthen the role of the Court of Auditors (*Corte dei Conti*) in budget monitoring and in providing independent evaluations of fiscal proposals and trends.

Directors welcomed the opportunity to consider the key findings of the Financial System Stability Assessment (FSSA) in the context of this discussion, and expressed their broad agreement with them. They welcomed the finding that Italy's financial system appears to be generally sound and well regulated, and encouraged the authorities to deal expeditiously with the issues identified in the FSSA. These include limited market contestability, high fees and commissions, and regulations covering loan classification and lending to related parties. Directors welcomed the steps underway to deal with some of these matters. A number of Directors noted the need for further improvement in efficiency and competition in the financial sector, including that which would result from increased participation by foreign banks. This would contribute to raising Italy's growth potential. Several Directors also encouraged Italy to move to a 90-day classification rule for non-performing loans.

Directors supported recent changes in the Bank of Italy's governance structure and the institutional arrangements for the oversight of banking competition. They welcomed the transfer of responsibility for anticompetitive behavior to the antitrust authority, which will help address the potential conflict between stability and competition in previous arrangements. Directors stressed the importance of ensuring that the new arrangements safeguard fully both the Bank of Italy's and the antitrust authority's high levels of independence, and establish the division of responsibilities between the two institutions along clear lines with distinct accountability.

Directors welcomed Italy's commitment to raise its relatively low level of development assistance. They also welcomed the authorities' commitment to continue to promote trade liberalization through a multilateral approach.

Directors noted that Italy's statistics are adequate for surveillance, and welcomed recent steps to address weaknesses identified in the 2002 Report on the Observance of Standards and Codes. They underscored the need to address remaining issues regarding the transparency and timeliness of some fiscal data and documentation.

Italy: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
Real economy (change in percent)					
Real GDP	1.8	0.4	0.3	1.2	0.1
Total domestic demand	1.4	1.2	1.2	1.0	0.7
CPI (average)	2.3	2.6	2.8	2.3	2.3
Unemployment rate (in percent)	9.5	9.0	8.7	8.5	8.1
Public finance (in percent of GDP)					
Overall balance	-3.0	-2.9	-2.7	-2.6	-3.2
General government balance	-3.2	-2.7	-3.2	-3.2	-4.3
General government debt	110.9	108.3	106.8	106.5	108.7
Money and credit (end of year, percent change)					
Private sector credit 2/	7.0	6.2	7.0	5.9	8.8
National contribution to euro area M3 3/	6.0	8.1	6.7	8.1	8.7
Interest rates (in percent)					
6-month interbank rate 4/	4.3	3.3	2.3	2.1	2.5
Government bond rate, 10-year 5/	5.2	5.0	4.2	4.3	3.6
Trade balance	1.4	1.1	0.8	0.7	-0.4
Current account balance	-0.1	-0.8	-1.3	-0.9	-1.9
Fund position (as of December 31, 2005)					
Holdings of currency (percent of quota)					82.6
Holdings of SDRs (percent of allocation)					22.8
Quota (millions of SDRs)					7,055.5
Exchange rates					
	Member of EMU				
Exchange rate regime					
Euro per U.S. dollar (January 30, 2006)				0.85	
Nominal effective rate (2000=100) 4/	100.4	101.6	105.8	107.2	106.5
Real effective rate (2000=100) 4/ 6/	101.1	104.2	111.4	113.7	110.1

Sources: Italian authorities; IMF, *International Financial Statistics*; World Bank, *World Development Indicators*; Bloomberg; Eurostat; and Fund staff estimates and projections.

1/ Staff estimates and projections, unless otherwise noted.

2/ Twelve-month credit growth, adjusted for securitizations. Data for 2005 refer to July.

3/ Excludes currency in circulation held by non-bank private sector. 2005 data refer to October.

4/ Data for 2005 refer to November.

5/ Data for 2005 refer to December.

6/ Based on CPI.

**Statement by Arrigo Sadun, Executive Director for Italy**  
**February 6, 2006**

**1. Introduction**

We wish to thank the staff for producing a very comprehensive report and for their successful mission. Following the Art. IV consultation and the extensive discussions with the European Commission (EC), the Italian authorities have introduced additional measures to strengthen the 2006 Budget. Accordingly, the deficit target for this year has been reduced to 3.5 percent of GDP, which will facilitate the authorities' efforts to bring it well below the 3 percent reference value by 2007.

**2. Economic Outlook**

The slow growth of the past few years has hampered fiscal adjustment. The authorities are committed to pursue a strategy based on fiscal consolidation and the completion of the structural reforms agenda. A gradual recovery is under way, and it is expected to strengthen in 2006. The main stimulus to growth will come from private consumption, fuelled by rising employment and gains in disposable income. Investment is expected to rebound, particularly spending on machinery and equipment, and the foreign sector is also forecast to improve. Inflation appears firmly under control at about 2 percent, and the differential relative to the euro area average has been narrowing. This macroeconomic scenario is broadly in line with staff projections.

**3. The reform strategy**

Faster economic growth will facilitate fiscal consolidation. However, a cyclical upturn will not resolve the fundamental problems of the Italian economy. These include low productivity and a substantial loss of competitiveness. The solution to these problems hinges on the successful implementation of the reform agenda along the lines of the Lisbon Strategy. Building on the measures already implemented in the labor market, the pension system, and education, the agenda aims at fostering greater competition and productivity in the services and product markets.

**4. Fiscal Policy**

Italy is firmly committed to respect the July 2005 EU Council recommendations, which call for a reduction of the deficit below 3 percent of GDP by 2007. This should be achieved through a correction of 1.6 percentage points in the cyclically-adjusted deficit (net of one-offs) over the 2006-2007 period, with at least half of the correction to be achieved in 2006.

For 2005, the authorities are confident that the deficit target of 4.3 percent of GDP will be achieved, as preliminary data indicate that the central government cash deficit was EUR 60 billion, 5 billion below the original projections.

As mentioned above, the 2006 Budget aims at reducing the deficit to 3.5 percent of GDP, which is 0.3 percentage points below the figure discussed with the staff at the time of the mission. The fiscal adjustment amounts to 1.4 percent of GDP, two-thirds of which are expenditure cuts and one-third additional revenues. These measures represent a correction of the cyclically-adjusted deficit, net of one-offs, of 0.9 percent of GDP. Although a formal assessment of the EU authorities will be approved in a few weeks, preliminary reactions are positive.

The Stability Program for 2006-09 confirms the target of reducing the deficit to 2.8 percent of GDP in 2007. This implies a further correction of 0.8 percent in the cyclically-adjusted deficit, net of one-offs. The Stability Program envisages also the reduction of the cyclically-adjusted deficit of 1.1 percent of GDP by the end of this decade. This target is lower than the so called "minimum benchmark," i.e. the deficit-to-GDP ratio necessary to respect the 3 percent reference value during normal cyclical fluctuations. The debt-to-GDP ratio is expected to decline to 101.7 in 2009.

## **5. Strengthening the expenditure controls**

To address the concerns expressed by staff during the Article IV mission and those of the EC, the final version of the 2006 Budget includes several measures that tighten the administrative controls on the expenditures of the central administrations, local governments, and the healthcare agencies. These include:

### Central Government

- Spending by each administration will be monitored on a monthly basis. In the event of spending overruns, the head of the agency will be personally responsible for taking immediate corrective actions.
- Procurement of goods and services for all administrations will be channeled through a central agency, CONSIP, the power of which has been strengthened to evaluate competitive bids and the merit of the requests.

### Local Government

- The Internal Stability Pact, which aims at ensuring that local-government expenditures are in line with the budget, has been further reinforced by imposing strict ceilings for spending other than personnel costs and social outlays.
- Compliance with budgetary guidelines by the regional authorities will be monitored on a quarterly basis. In the event of healthcare expenditure overruns, the President of the Region has thirty days to take corrective measures. Failing this, there will be a mandatory increase in regional taxation.

### Health Care Agencies

- The Ministry of Health has launched a new system to closely track healthcare expenditures. An electronic "health card" has been introduced with the intent of

monitoring individuals' expenditures and preventing fraud and waste. The role of the Pharmaceutical Agency has been expanded to monitor spending on drugs and to contain related prices.

#### Court of Auditors

- In line with staff recommendations, the role and capabilities of the Court of Auditors (Corte dei Conti) has been strengthened. Moreover, its mandate has been extended to monitor the finances of local governments and healthcare agencies.

### **6. Ageing-related costs and fiscal sustainability**

As was the case last year, the authorities believe that the macroeconomic assumptions used by the staff in their long-term fiscal sustainability exercise are overly pessimistic. Specifically, the staff assumes that for the entire period 2005-2050 real GDP growth will average just 0.75 percent (less than half the EU average), while productivity is expected to average just above one percent. Thus, the increase of the public debt reflects these pessimistic macroeconomic assumptions, rather than the growth in age-related expenditures. By contrast, the Italian authorities in their most recent Stability Program use different assumptions that are also shared by the EC. Specifically, they project: a) an average real GDP growth of 1.3 percent; b) a productivity rate that increases gradually from the current 0.7 percent to 1.7 percent in 2030 and thereafter; c) a participation rate that raises by 8 percentage points by 2050 (largely due the contribution of women; c) an unemployment rate that declines from the current 8 percent to 6.4 percent by the end of the period. According to the recent EC report *Age-related public expenditure for the EU25 Member States up to 2050*,<sup>1</sup> public pension spending in Italy is expected to increase by 0.3-0.4 percent of GDP from 2005 to 2050. This is one of the smaller increases in the EU and reflects the cumulative impact of the reforms introduced in the past several years to modify the pension system. During the same period, healthcare expenditures are expected to increase by 1.4 percent, less than the EU average.

### **7. Structural Reforms**

The surprisingly good performance of the labor market during this prolonged period of slow growth confirms the effectiveness of the reforms introduced in the past years. Although some of the improvement reflects the regularization of illegal immigrants, past reforms have increased the flexibility of the labor market and facilitated women's participation.

The authorities concur with the staff on the need to shift the balance from employment protection to enhancing the social safety net. Pending the approval by Parliament of the second wave of labor market reforms, several measures were adopted in 2005, including an increase in unemployment benefits and the introduction of active labor market policies.

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<sup>1</sup>See ECFIN/CEFCEP(2005) Brussels, 23 December 2005.

### The Renewed Lisbon Agenda

The authorities agree with the staff on the need to pursue an ambitious agenda of structural reforms in order to address the underlying problems of the Italian economy. The first national Plan for Innovation, Growth, and Employment (PICO) is a comprehensive blue-print developed in accordance with the Renewed Lisbon Agenda. The Plan addresses the main weaknesses of the economy. In particular, it aims at streamlining administrative procedures, liberalizing the services markets, and stimulating the accumulation of human capital.

### Privatization

As announced in last year's Buff statement, the 2005 privatization measures included an additional 10 percent sale of the capital stock of the power utility ENEL, reducing the government holdings to 31 percent. Further asset sales, amounting to 0.7 percent of GDP, are planned in 2006.

The 'Poison pill' provision, introduced in the Italian legal system with the 2006 Budget Law, is not meant as a substitute for golden shares, having a different content and rationale.<sup>2</sup>

### Law Reforming Bankruptcy Procedures

Last December, the Parliament approved a series of reforms long advocated by staff. They include revamped legislation concerning bankruptcy and civil procedures. The new Law on Bankruptcy streamlines procedures, favors an early access to the procedures by reducing the sanctions for the bankrupt debtor, reinforces the role of reorganization procedures and introduces the possibility for debtors to negotiate, out of court, restructuring agreements to be submitted to the bankruptcy judge.

### Law on Savings

The Law on Savings, recently approved, addresses several issues including: corporate governance; the role and capabilities of Supervisory Authorities; the governance of the Bank of Italy, including the ownership structure, the role of the Board of Directors, and the Governor's term of office. The Law's main objectives are to improve corporate governance of listed companies, increase transparency, and enhance consumer protection. To these aims, Consob's resources and sanctioning powers have been increased; minority shareholders' rights have been enhanced; more stringent rules on external auditors have been introduced; the compliance with the Corporate Governance Codes has been reinforced. In addition, the Law subjected banks to the obligation of publishing a full prospectus for unlisted bonds also, which is approved by Consob. It is worth noting that Consob has been very active in imposing sanctions on banks whenever they misbehave with respect to the provision of investment services to retail investors.

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<sup>2</sup> Italy has recently responded to the remarks on the golden share put forward by the Commission in the context of the infringement proceedings initiated against several European countries.

Finally, the Law transferred the antitrust functions in the banking sector from the Bank of Italy to the Antitrust Authority and introduced tighter rules as regards the prevention of conflicts of interest in connected lending.

## **8. The Financial Sector**

Both the Article IV staff paper and the FSSA agree that the Italian banking and financial sector is generally sound and well regulated. However, this positive assessment is overshadowed by the characterization of the banking system as fragmented, with a very small presence of foreign banks in retail markets, with a weaker degree of competition vis-à-vis other countries, and with relatively high operating expenses and costs of services. This representation is not borne out by the empirical results presented by staff's paper and by available evidence.

### Consolidation

In the last decade mergers and acquisitions (M&A) involved target banks accounting for half of the system's total assets. The value of the banks' M&A in the period 1996-2005 was higher in Italy than in other large continental countries. The Herfindahl-Hirschman concentration index increased by 40 percent between 1998 and 2004 instead of by 11 percent as reported in the IMF selected issues paper. The consolidated market share of the top five banking groups is now about 50 percent, in line with the European average.

### Foreign banks

The role of foreign intermediaries has significantly increased. Foreign branches and subsidiaries account for 8 percent of the banking system's total assets, which, as staff acknowledges, is "similar to the share in other western European countries." Moreover, foreign banks and other foreign investors are important members of the shareholders' agreements controlling the main Italian banking groups. Foreigners hold an average of 16 percent of the capital of the four largest banking groups, a share higher than in other large continental countries.

### Contestability and Competition

The privatization process in the financial sector, which began in the early 1990s, is almost completed. All large and almost all medium-sized banks are listed. A large number of indicators - such as the number of banks in local markets, the turnover in market shares, and interest rate spreads - show that competition in the banking sector has greatly increased and is comparable to that of other large European banking systems. This is confirmed by the IMF's empirical evidence and by the literature quoted in the staff paper. Thus, the final staff appraisal seems to diverge from the results of their own analysis.

### Bank performance

Operating costs as a ratio to bank assets are indeed relatively high in Italy but, in the international comparison, this indicator is biased as Italian banks offer labor intensive retail asset management services that in other countries are largely provided by non-bank financial

intermediaries. Moreover, interbank claims are relatively low due to the efficiency of the screen-based markets (interbank and Government bond markets).

Comparisons based on the cost-income ratio, which is less biased by differences in the composition of output, show a different picture. According to official ECB data, in 2004 the Italian banks' cost-income ratio was almost 6 percentage points lower than the average for the euro-area. Asset quality has significantly improved as far as the flow of new bad debts is concerned. On average, between 2001 and 2004 new bad debts were equal to 1 percent of loans outstanding at the beginning of each year. The ratio was about 4 percent in the recession of the early 1990s and remained above 2 percent until 1996. The relatively high stock of non-performing loans is partly due to the length of bankruptcy procedures. The authorities are committed to implement the standard 90-day past-due classification before the transitory period allowed by the Basel committee (i.e. 2012).

## **9. ODA**

Italy fully shares the EU commitment to reach an ODA-to-GDP ratio of 0.56 percent by 2010. The authorities will make all efforts to meet, by the end of 2006, the target of 0.33 percent; this doubles the 2004 results and serves as an intermediate goal to achieving the target of 0.5 percent in 2010, as agreed in Barcelona and Monterrey.