

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.

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 Deppler 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.

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 broadbased 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.

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. revised deficit target of 4.3 percent of GDP was 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.³ 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 factors accounting for Italy's loss of competitiveness.** 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.

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C. The Agenda for a More Competitive Italy

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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.

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. 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**
- (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. 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.

Source: Eurostat - 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

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• **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.

(Traduzione)

Un insieme regolatorio inibisce la competizione nei servizi professionali (posto che il costo dei servizi professionali è tra i più alti d'Europa – vedi tabella sopra) anche sbarrando la strada ai NON-riconosciuti di svolgere mansioni non-tecniche, stabilendo tariffe minime per certe attività (come a dire troppe attività) attraverso la proibizione della pubblicità (per troppe attività). Gli ordini costituiscono una barriera formidabile per l'accesso alle professioni che rimangono ampiamente impermeabili, dato che la maggior parte dei servizi professionali ricadono quindi al di fuori del controllo anti-trust. Il Governo ha dimostrato un certo interesse per l'eliminazione di queste restrizioni, anche se le associazioni professionali e la liberalizzazione delle tariffe minime sono già state prese in considerazione come necessari (come sappiamo dai disegni di legge mai approvati) per favorire la qualità e la protezione dei consumatori. Nessuna iniziativa di rilievo ha visto luce, anzi, la progettata riforma del notariato è stata cassata. Tuttavia il tema è ben presente nel dibattito elettorale..

• 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 incentives to resist cost pressures and innovate, as pointed out by the OECD.¹⁰ 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, 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

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.¹¹

OECD (2005) *Economic Survey: Italy*.

Italy--Business Environment	<i>Italy</i>	OECD avg.
Cost of Starting a Business (in pct per capita GDP)	15.7	6.8
Rigidity of Employment Index (An overall measure that captures hiring and firing costs, plus rigidity of hours worked. Higher numbers indicate a more rigid environment.)	57.0	36.1
Legal Framework to Facilitate Lending (Measures how well collateral and bankruptcy laws facilitate lending. Higher numbers denote a more supportive environment for granting credit.)	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

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 stressed by the trade unions.¹² 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.

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.