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May 24, 2021

**Statement by Mr. Merk and Ms. Koh on Italy  
(Preliminary)  
Executive Board Meeting  
May 26, 2021**

**We thank staff for the insightful report and Mr. Fanizza for the detailed Buff. We broadly agree with the thrust of the appraisal.** Italy has been severely affected by the Covid pandemic, and we commend the authorities for their rapid and commensurate policy measures to limit the negative effects on citizens and the economy. While it has been paramount to allocate sufficient and targeted resources to fight the crisis, it will be important to prepare the economy for the medium- to long-term challenges once the crisis abates. In doing so, particular attention should be paid to **credibly bringing back public debt on a sustainable trajectory, ensuring efficient execution of public investment, curtailing wasteful spending, streamlining civil justice and eliminating barriers to private investment.**

**We associate ourselves with Mr. Pösö's statement and in addition would like to emphasize the following points:**

**We agree with staff that a credible plan to bring down public debt is key to anchor a sustained and significant reduction in the public debt ratio by the end of the decade in order to ensure sustainable public finances.** Over the medium- and long-term, pressure on fiscal sustainability might increase noticeably (induced by e.g. a reversal of the currently very favorable interest-growth-differential or rising pension spending). We therefore encourage the authorities to start consolidation once the economy recovers. Meanwhile, the income and liquidity measures that remain necessary until the recovery is entrenched should be targeted to those who remain most affected.

**Given decade-long weak growth and low (private and public) investment, the NRRP rightly envisages a boost to public investment, but we agree with staff that this strategy hinges critically on the efficiency of spending.** Low and at times inefficient public

investment, weaknesses in absorption capacity of European funds and public administration as well as impediments to private investment have contributed to Italy's gaps in physical, digital and social infrastructure and ultimately to low trend growth. We therefore welcome the frontloaded structural reforms envisaged to enhance the efficiency of public spending, curtail wasteful spending, reduce the burden of bureaucracy on the private sector and streamline civil justice. These measures are all the more important, given that the projected fiscal position is subject to significant downside risks, highlighting risks surrounding the DSA's baseline scenario. On the maturity structure of government debt, we agree with staff's findings that this has been extended in many countries. However, government bonds purchased by central banks are ultimately linked to the ECB deposit rate via the balance sheet connection between the central bank and public finances. This has caused such purchases to de facto shorten maturities, as central banks' profits depend on short term deposit rates. As a result, a normalization in monetary policy would lead to larger fiscal burdens than the official maturity structure indicates. Moreover, it would be helpful to list sustainability risks of public finances as an own category in the risk assessment matrix (annex II). *Staff's comments are welcome.*

**In addition, tax loopholes should be removed, also to increase the equity of government tax and spending frameworks.** Against this backdrop, and also with a view to the relatively large tax wedge on low wage earners, we see merit in staff's call for a base-broadening tax reform to promote growth and inclusion while tackling tax evasion. *In this context, we were surprised by the recent amnesty on old tax liabilities, which could set a precedent for weakening future tax compliance and would welcome additional staff comments on this.*

**Non-performing loans (NPLs) are expected to rise again in response to the recession.** To enhance NPL workouts, we encourage the authorities to address weaknesses in debt recovery frameworks and out-of-court debt resolution mechanisms, and to bring forward the civil procedure reform in order to allow for timely workouts of non-performing loans. This would also reduce the risk of a vicious cycle between the sovereign, corporates and banks, the linkages among which have risen. In addition, to contain risks for public finances, we agree with staff that incentives for prudent management of guaranteed lending should be strengthened.

**Tackling impediments to Italy's business environment is crucial for sustainable and long-lasting growth.** Staff highlights that chronic weak productivity and uncertainty about medium-term growth prospects continue to dampen investment and consumption in Italy. We agree on the reform priorities that are key to improve the business environment. These include the implementation of the new insolvency code, the long-awaited civil procedure reform and lowering regulatory barriers to competition. We appreciate that the authorities agreed that the private sector is best positioned to identify viable firms and the amount of financing to support those firms. We agree with staff that this would limit moral hazard and

diversify risk, backed by co-financing or insurance by the state focusing on countering potential private under-provision from a societal perspective.

**We echo staff's call for strong governance of public investment as another central aspect of improving the business environment.** As noted by staff, relevant elements include providing information on large-benefit recipients, publishing ex post audit reports on crisis-related spending and reviewing eligibility of support programs to individual recipients in order to make sure that public investment is aligned with the overall objective.

**With regard to the labor market, while overall income and employment losses have been contained, the short term working schemes and the ban on layoffs have provided less protection to the young and to women** who have been severely affected by the crisis. Against this backdrop, we appreciate the authorities' efforts to stabilize employment, starting in 2021 with specific social security arrangements. We would note, however, that this is not a sufficient substitute for a long-term strategy to promote employment.

**We welcome the authorities' intention to boost spending on environmental projects.** In this context, we take note of staff's statement that "*climate change mitigation measures imply the economy may not fully revert to its pre-pandemic configuration*". *Could staff elaborate somewhat on this statement? More specifically, what is staff's assessment of the climate change transition and mitigation measures with regard to their effectiveness, and have potential positive effects on the labor market been included in the analysis? Does staff envisage to cover transition and mitigation aspects of climate change during Italy's next Article IV consultation?*