

**FOR
INFORMATION**

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July 26, 2022

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Italy—Statement by the European Central Bank Representative**

Board Action: Executive Directors' **information**

Additional Information: For the Executive Board discussion on Italy to be held on Wednesday, July 27, 2022.

22 July 2022

**Statement by Rasmus Rueffer (ECB Representative) and Sander Tordo (Advisor) on
Italy – 2022 Article IV Consultation
IMF Executive Board Meeting**

27 July 2022

We broadly agree with the Staff's assessment on the macroeconomic outlook for Italy. The Italian economy has rebounded strongly from the pandemic-induced shock, also thanks to the appropriate policy response, with output reaching its pre-crisis level in the first quarter of this year. However, the spillovers from Russia's war against Ukraine add to existing vulnerabilities and are expected to result in a sharp slowdown in growth, with the balance of risks further tilted to the downside. We concur with Banca d'Italia's upward revision to real GDP growth in 2022 (3.2%; Economic Bulletin, 15 July 2022) that brought it in line with the Staff's projections. The reassessment, compared to the June Euro system projections, incorporates the latest readings about a stronger than anticipated performance of the high-contact service sector and industry enhanced resilience to energy shocks. We are somewhat more optimistic on Italy's economic performance in the coming years than Staff and expect more balanced growth, driven by strong investment and a more positive contribution from private consumption. Economic growth in Staff's projections is largely driven by buoyant investment, with public investment spurring private investments. We are less optimistic on investment as the high uncertainty affects primarily capital good spending. Amid weak wage developments, aggregate consumption has benefited from compensatory energy measures and accumulated savings, which will continue to partly offset the contraction in real disposable income due to inflationary shocks. On the labour market, Staff is more cautious, while we also foresee further improvements ahead, amid weak dynamics in the labour force participation rate recorded so far. The decline in unemployment is expected to continue.

We share the analyses by Staff on past inflation determinants, but our latest projections for inflation dynamics is somewhat different. Following the higher than expected June inflation readings, we have reassessed upward HICP inflation in 2022. Banca d'Italia (Economic Bulletin 15 July 2022) raised it to an annual average of 7.2%, while confirming the June 2022 Eurosystem projections at 2.0% in 2024. By contrast, Staff projects somewhat weaker inflation dynamics in 2022 but sees it as more persistent through time at 2.9% in 2024.

Like Staff, we see that risks to the real GDP growth outlook are tilted to the downside, and for inflation to the upside. A prolonged curtailment of gas supplies that would jeopardise the country's ability to replenish stocks ahead of the winter season is the main downside risk. Among the downside risks not explicitly discussed in the article, the recent political instability represents another source of potential concern. The very high debt-to-GDP ratio may give rise to rapid reassessment of Italy's debt sustainability and associated widening of the interest rate spreads, with consequences for financing conditions in the real economy.

We agree with Staff that Italy needs a credible and well-designed multi-year fiscal strategy. Clear communication will be crucial to anchor market expectations. In that context, a successful implementation of the Recovery and Resilience Plan is crucial for debt sustainability, as it can contribute to lifting the long-term growth potential. It is also equally pivotal to implement additional fiscal-structural reforms to

broaden the tax base and reduce especially current primary spending. Additional to the increase in debt due to the Covid-19 pandemic, Italy faces strong ageing spending pressures. We thus agree that the current compensation for high energy bills should be temporary, target vulnerable households and viable firms, while signalling the government's commitment to a declining deficit path. Should potential growth be lower than assumed, in line with historical trends, risks to sustainability would increase.

Turning to structural policies, we broadly share the Staff assessment that key risks for the Italian economy remain elevated and require appropriate economic policies. New headwinds from high inflation, in particular energy prices, geopolitical risks and the expected normalisation of policy rates will add new risks to the Italian economy. The exit from the pandemic requires Italy to implement a swift removal of both wage subsidies and untargeted income support to households and firms. In the context of the Russian war on Ukraine, tailored policy measures aimed to ensure the functioning of the energy market can be considered. In view of the surge of inflation, we see merit in Staff's argument in Box 1 that a three-year forward-looking measure stripped down from the energy component as the benchmark for wage indexation is a good policy that should be safeguarded in the near term; this will help to avoid second-round effects and contribute to keep inflation expectations anchored. In general, it is worth highlighting the benefits of moving towards more decentralized wage agreements. These would provide the necessary flexibility in the labour market, while partly accounting for differences in regional and firm-level productivity developments.

Italy is already delivering on its comprehensive and well-designed RRP, and its full and timely implementation is crucial to raise Italy's growth potential and secure sustainability considering existing challenges. The share of front-loaded reforms compared to investment projects is welcome and should encourage private investment as well. The effectiveness of the plan in boosting potential growth hinges on policy continuity. Addressing risks from corporate sector indebtedness because of the pandemic or energy crisis may pose future challenges in terms of contingent liabilities for the public sector. To this end and given backlogs of the Italian civil justice, preventing a surge in insolvency cases is key to avoid large inefficiencies in private markets. In this respect, it would be key to support out-of-court debt resolution mechanisms by expanding out-of-court capacity. Concerning the structural issue of declining productivity, we agree with the Staff view that a holistic approach, made of several synergic policies, is to be preferred. We welcomed the effort to conduct an empirical analysis of productivity enhancing determinants. To guide policy makers in selecting/designing policies to be prioritised, the common factor identified in the analysis should be traced back to a subset of the policy-relevant variables at stake.

We broadly agree with the Staff assessment regarding financial stability developments and challenges in Italy. The Italian banking sector has managed to weather the pandemic-related economic disruptions rather well, supported by government measures such as publicly guaranteed loan schemes and loan moratoria. The resilience of the banking sector has been bolstered in recent years, for instance by increasing bank capital buffers and further reducing the aggregate ratios of Non-Performing Loans (NPLs) to 3.4% as of end-2021, the lowest level since the global financial crisis. However, financial stability risks are rising in an environment of lower economic growth, high inflation, elevated uncertainty and more challenging market conditions. We thus broadly concur with Staff that at the current juncture it would be

prudent for Italian banks to apply caution in the use of capital for share buy-backs or dividend pay-outs in order to retain sufficient capital buffers for potential downside scenarios.

As regards bank supervision, we agree with the recommendation that Italian competent authorities continue to address weaker banks, whose profitability and business models could be further challenged by the sequential crises. This recommendation is particularly relevant for the supervision of less significant institutions. Although significant progress has been achieved in the last few years to improve banks' governance arrangements and to enhance the timely implementation of corrective measures (including early intervention measures), the authorities should keep promoting turnaround processes of weak less significant banks through different initiatives (including combinations with other banking/financial partners). Lending conditions to the corporate sector remain favourable and benefit from stable funding costs of the Italian banking system. This is also a signal that, until now, the increase in government bond spreads has had no material impact on private sector lending conditions. This also reflects favourable borrowing conditions for banks via ECB TLTRO III operations. However, in line with Staff's view, we assess that tightening financial conditions are likely to adversely affect funding costs for Italian banks and, as a consequence, corporate and household lending conditions may be linked more closely to Italian government bond yields. The SSM is following closely the current situation, which includes not only the macroeconomic development, but also the yields and spreads that can cause fluctuation in banks' capital.