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Italy—2022 Article IV Consultation

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Staff: van Elkan, EUR; Zettelmeyer, SPR

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CEDA OGADA
Secretary

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¹ Minutes are the official record of a formal Board meeting in which the Board may adopt decisions and reach understandings related to the business of the Fund. Staff background documents issued before the meeting are the principal basis for the meeting. Preliminary “gray” or “buff” statements by Executive Directors and staff’s responses to Directors’ technical questions are circulated prior to the meeting. Adopted decisions and/or summings up—the Chair’s “sense of the meeting” or policy conclusions/recommendations—are issued after the meeting. The minutes include all these elements, as well as the discussion record (a verbatim transcript of the discussion lightly edited for clarity). Minutes are made public consistent with the IMF’s Open Archives Policy.

THE ACTING CHAIR'S SUMMING UP

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' effective pandemic policy response, which delivered a robust and full recovery. However, major new challenges brought about by elevated energy prices related to Russia's invasion of Ukraine, as well as tightening financial conditions, global supply chain disruptions, and political uncertainty have considerably dimmed the economic outlook. Together with longstanding weak productivity, these factors bring to the fore risks associated with Italy's high public debt.

Directors underscored the need for sustained, decisive improvements in fiscal balances, commencing this year by saving part of revenue overperformance. They commended the authorities' pre-emptive efforts to strengthen the security of energy supplies and recommended that compensation for higher energy prices be temporary and targeted, and that price signals be retained. Rationalizing current spending, broadening the tax base, strengthening tax compliance, and implementing growth-enhancing reforms—including public administration, civil justice, and competition—are needed to achieve and maintain a sizable primary surplus to keep public debt on a firmly downward path.

Directors welcomed the resilience of the banking sector to the pandemic shock but suggested caution given the highly uncertain outlook. Banks should prepare for severe downside scenarios and temporary capital conservation may be warranted in specific cases, including to cope with potential weakening of asset quality. Continued close monitoring, including of smaller and weaker banks, will be important. More efficient debt restructuring to help firms avoid financial distress would also be necessary. Directors commended the progress in implementing the FSAP recommendations and encouraged prioritizing key remaining recommendations.

Directors welcomed the authorities' commitment to their National Recovery and Resilience Plan and commended the timely implementation of Next Generation EU-related targets and milestones. They recommended continued steadfast progress to lift labor productivity, investment, and potential growth, as well as accelerate the green transition. Efficient execution of public investment and strong reform momentum will be essential for success. Improving carbon tax design, making green investment incentives more cost-effective, and streamlining approval procedures for investments in renewables would help accelerate decarbonization and strengthen energy security. A number of Directors saw merit in a coordinated EU approach on carbon taxation. Directors encouraged a continued strengthening of the anti-corruption and AML/CFT frameworks.

It is expected that the next Article IV Consultation with Italy will be held on the standard 12-month cycle.

EXECUTIVE BOARD ATTENDANCE²

G. Gopinath, Acting Chair

Executive Directors

I. Mannathoko (AE)

C. Huh (AP)

A. Bevilaqua (BR)

Z. Zhang (CC)

P. Moreno (CE)

P. Jennings (CO)

D. Palotai (EC)

J. Stephan (GR)

S. Bhalla (IN)

D. Fanizza (IT)

J. Mizuguchi (JA)

H. Hosseini (MD)

P. Hilbers (NE)

A. Mozhin (RU)

R. Lim (ST)

S. Riach (UK)

Alternate Executive Directors

F. Sylla (AF)

B. Lischinsky (AG), Temporary

C. Roman (FF)

A. Alhosani (MI)

A. Marcussen (NO)

M. Alrashed (SA)

M. Peter (SZ)

C. Westphal (US), Temporary

S. Bhatia, Acting Secretary

J. Morco, Summing Up Officer

E. Mannefred, Board Operations Officer

L. Nagy-Baker, Verbatim Reporting Officer

Also Present

Communications Department: M. Louis. European Central Bank: R. Rueffer, S. Tordoir.
 European Department: E. Crivelli, J. Decressin, L. Jirasavetakul, A. Shabunina, G. Tolosa,
 R. van Elkan, D. Velazquez-Romero, Z. Zhang. Fiscal Affairs Department: A. Nguyen.

² For countries in each constituency, please see the Constituency Codes in the annex.

Institute for Capacity Development: X. Feng. Legal Department: N. Stetsenko. Monetary and Capital Markets Department: U. Das. Strategy, Policy, and Review Department: N. Budina, J. Zettelmeyer. Statistics Department: P. Tumbarello. Executive Director: A. Andrianarivelo (AF), A. BinZarah (SA), A. Buisse (FF), S. Chodos (AG), M. Mohieldin (MI), M. Poso (NO). Alternate Executive Director: C. Amarasekara (IN), H. Azal (EC), L. Dresse (NE), M. El Qorchi (MD), F. Fuentes (BR), A. Grant (AP), A. Guerra (CE), C. Just (EC), M. Kashima (JA), M. Massourakis (IT), F. Mochtar (ST), W. Nakunyada (AE), F. O'Brolchain (CO), O. Parkyn (AP), S. Potapov (RU), J. Romero (CE), B. Saraiva (BR). Senior Advisors to Executive Directors: A. Abdullahi (AE), E. Cartagena (CE), M. Choueiri (MI), V. Grossmann-Wirth (FF), A. Medearis (US), T. Nguema-Affane (AF), C. Quagliarini (IT), J. Rojas (CE), H. Saeed (SA), C. Sassanpour (MD), F. Spadafora (IT), N. Thiruvankadam (IN), M. Trott (UK). Advisors to Executive Directors: F. Al-Kohlany (MI), P. Al-Riffai (MI), D. Andreicut (UK), R. Bah (AF), E. Boukpepsi (AF), L. Cerami (IT), J. Corvalan (AG), K. Dacharux (ST), R. Fayez (MI), E. Fisher Hogan (BR), D. Hamzah (MI), Z. Huang (CC), Z. Huang (CC), P. Khademi (GR), A. Korinthios (IT), R. Kraavik (NO), T. Krahnke (GR), C. Kuth (SZ), V. Lankester Campos (CE), C. Mastrapasqua (IT), M. Mengistu (AE), M. Merhi (MI), D. Milutinovic (NE), P. Mooney (CO), R. Moral Betere (CE), I. Ogihara (JA), A. Ribeiro Mateus (IT), I. Valdes Fernandez (NO), J. Yoo (AP), F. Lopez (CE).

DISCUSSION RECORD³

The Acting Chair (Ms. Gopinath):

Italy's economy has rebounded strongly from the pandemic-induced shock supported by an appropriate policy response. Output has returned to its pre-COVID level in the first quarter of this year. However, the rise in energy and food prices related to Russia's invasion of Ukraine, as well as tighter financial conditions, are severely weakening growth prospects in the context of very high public debt. The resignation of Prime Minister Draghi last week has increased political uncertainty at a time when Italy could be facing further disruptions to its gas imports.

Against this background, Mr. Fanizza's buff statement and Directors' gray statements highlight several key issues. One is how to reinvigorate trend growth and ensure public debt remains on a firm downward path. Second was the impact of higher gas prices on growth. Third, whether Italy will benefit from ECB's new Transmission Protection Instrument (TPI); and, finally, implications for member countries that are moving forward with climate policies in the absence of a coordinated EU approach. I very much look forward to hearing from Directors on these questions particularly and their views.

Mr. Fanizza:

I would like to thank Ms. van Elkan and her team for all their work and for the constructive approach to the discussion. The authorities have much appreciated their input.

There is much attention on the recent political developments that have led the President to call for a snap election for September 25 during this time of uncertain economic situation. There is a problem. But I have two remarks given this context.

First—this is quite important—the Draghi government remains in charge for the next two months with four clear tasks. First, it can issue emergency decree laws as needed—it is up to the government to decide—on energy, the pandemic, and the war. Second, it can issue implementation decrees for legislation that has already been approved by Parliament. Third, it can take a decision to implement the National Recovery and Resilience Plan

³ Edited for clarity.

(NRRP). Fourth, it will prepare the update to the 2022 economic and financial document that provides the macroeconomic assumption and the baseline budgetary projection that the new government will have to use for the 2023 budget, and this will be presented on September 27. The objective here is to cement the progress achieved so far this year and make it easier for the future government to stick to the reform agenda and quickly approve a new budget.

Second, it is a bit of a piece of history. In 2019, two parties that withdrew their support to Mr. Draghi formed a government promising that policies would drift away from fiscal consolidation. The fiscal outcome for 2019 recorded the largest fiscal effort since 2013 with a structural balance that improved by 0.7 percentage points of GDP. Actual fiscal policies often can differ substantially from political and electoral plans.

Some Directors also referred to debt sustainability challenges. I would like to place this idea in a context. My authorities and I believe strongly that the debt-to-GDP ratio for Italy is too high. It should go down. However, as compared to other G7, Italy does not strike me any longer as a complete outlier. Only one country is clearly below the 100 percent mark, so let us put things in context. In the short-term, there are obviously non-sustainability issues given the seven-year average debt maturity and the fact that debt issued to roll over maturing securities still pays much lower interest, the staff report does a good job in explaining the debt dynamic. From the Debt Sustainability Analysis (DSA) in the staff report, it is clear that the debt-to-GDP ratio starts to rise from 2013, reflecting the dismally low potential trend output growth, and adverse demographics. The ongoing reforms should help to lift growth over the longer term and coupled with a primary surplus of around 2 percent of GDP, should be capable to modify this projected path. And staff agrees with it.

Finally, on the debt sustainability, Mr. Stephan had a question on the Italian debt statistics. This is a bit of a sensitive issue. I wish to stress that Italian debt statistics comply with the highest standards of integrity, transparency, and completeness, fully in line with the European statistical requirements. Italy has been an SDDS Plus member since February 2015; I am not sure all the G7 members are. Staff has answered the question correctly, but I do not understand where it came from.

Most Directors at least underlined the tremendous transformation the Italian financial system has gone through. It has now become an element of strength and resilience from being a significant vulnerability only a few years

back. Nevertheless, a few gray statements point to lingering risks that I would like to address.

First, because of the significant bank holdings of government securities, higher interest rates may have an adverse effect on banks' regulatory capital when the prudential filter level expires. The impact is likely to be small at best, at least. The bulk of these securities are held at an amortized cost, 77 percent for smaller banks, 65 percent for systemic banks. The Bank of Italy has estimated that 100 percentage point increase in interest rates would translate only in a 0.2 percentage point decline in the average capital ratio, so not a big deal.

Second, on nonperforming loans, the drop in nonperforming loans (NPLs) has been nothing short of remarkable. Still, staff and a few gray statements point to public guarantees on securitized NPLs as a possible source of risk. I have three points to make here.

So far, no guarantees have been called on securitized NPLs, never used. The annual collection rate of securitized NPLs has been above 30 percent, which is not bad at all; so the 100 billion figure, I do not understand where it comes from. The financial health of the Italian corporates and the household sector have been invaluable. The overall private debt amounts to 65 percent of GDP, almost 10 percentage points lower than the European average.

Let me conclude here saying that I believe my authorities have made substantial progress in placing the Italian economy on a stronger footing. They have also managed to set the train of economic reforms in motion. In fact, the train has gained speed. I am confident that at this point of the ride, stopping or slowing the train will prove extremely difficult.

The staff representative from the European Department (Ms. Van Elkan):

We have addressed many of the questions in our written responses yesterday. Let me respond to a few remaining issues. First, the gas situation continues to remain volatile. Today, it seems that Italy is receiving around 40 percent of its normal gas supplies from Gazprom. This is up a bit from the last couple of weeks, but as I said, the situation is volatile, and it can change quite dramatically from day to day.

One of the issues that the Directors raised was related to how we view the debt reduction strategy, and so let me make several points on that front.

We see the need both to raise potential growth and to maintain a strong fiscal balance. Growth is important because it has a dampening effect when debt is high because growth multiplies the stock of debt. Given that Italy has very high debt and its growth is low, we think it is imperative to operate on both the fiscal and the growth margins simultaneously.

We also proposed reaching and then maintaining a primary surplus of 2 percent of GDP. Keeping a primary surplus at that level implies a very significant fiscal effort during the next 10 to 15 years when population aging would be pushing up pension spending by about one 1-1/2 to 2-1/2 percent of GDP per year. Sticking to the primary surplus target therefore avoids the large rebound in the debt ratio that would otherwise have occurred and instead keeps debt on a continuously declining path.

We should also ask if our primary surplus target is appropriate, I think two considerations are relevant here. First, as discussed in the report, the recommended primary surplus depends on trend growth and financing costs. So as expected, weaker potential growth or higher interest rates demand a more ambitious primary surplus target to counteract the more adverse automatic debt dynamics.

Second, the quality of fiscal adjustment also matters through its effect on output. We call for cutting low quality inefficient spending, which presumably carries a small fiscal multiplier. However, as fiscal effort increases, presumably more and more productive spending would have to be foregone, such as spending on public infrastructure or education; or in the case of taxes, higher rates would bring more distortions. It seems reasonable to expect that successively higher fiscal consolidation would be associated with increasing fiscal multipliers and greater hysteresis effects. This implies that marginal output losses would also be increasing, and at some point it could even be that consolidation becomes counterproductive for debt dynamics.

Just a word on the ECB's new Transmission Protection Instrument, which is intended to counter disorderly market dynamics in any euro area member country. This instrument is now in the toolkit but may or may not be used. Eligibility requires no excessive fiscal or macroeconomic imbalances, full compliance with the NRRP, and having sustainable public debt. Activation is at the discretion of the ECB based on its determination of whether disorderly market conditions exist. It would be reasonable to expect that the ECB would apply a high bar for assessing market dysfunction.

On climate policies, a number of Directors urged caution on raising carbon taxes when energy prices are already high or in the case of an individual country front running a coordinated EU approach. We are certainly aware of the issues that this could bring in terms of competitiveness and social cohesion. What we are really emphasizing is that Italy has plenty of scope to revamp its existing climate policies to make them more effective and without raising the overall energy taxes, and even saving money on subsidies.

Ms. Marcussen:

We have issued a gray statement, and we would like to raise a few points just for emphasis.

It is clear that Italy rebounded strongly from the pandemic shock, thanks to the appropriate policy response too. Output reached its pre-crisis level in the first quarter of this year, but the spillovers from Russia's war against Ukraine are expected to bring growth to a sharp slowdown with the balance of risks tilted to the downside and in particular due to the possibility of a prolonged curtailment of gas supply. We appreciate the comments from staff on this issue as well.

In this context, policy should stand ready to react to the evolving economic situation but be prudent and carefully designed, also taking into account the high level of public debt and sustainability challenges. We hear Mr. Fanizza today on debt dynamics. Thanks for those comments as well. Although the fact that Italy is no longer alone in this situation is maybe not entirely reassuring. Over the medium-term, policies should definitely be aimed at achieving debt reduction through gradual consolidation with a credible and well-designed multiyear fiscal strategy.

At the same time, and quite importantly, ensuring sustainability also requires a strong emphasis on reforms and investments which aim at raising growth potential in the economy. Italy is already delivering on its comprehensive recovery and resilience plan, of which a full and timely implementation will be crucial to address structural bottlenecks to growth and boost productivity. The NRRP has a high share of frontloaded reforms, which is very welcome and will help crowd in additional private investments. In this context, policy continuity will be key to make the NRRP a success.

Final point, on financial sector, we note that the resilience of the banking sector has improved in recent years, also supported by government measures such as public guarantees and loan moratoria. However, financial

stability risks are rising in the context of a challenging macroeconomic and political environment, and therefore retaining sufficient buffers for potential downside scenarios is crucial. In particular, we are thinking of some of the less significant institutions. On these, governance has been significantly improved, and the authorities should keep promoting turnaround processes of weaker banks, including through consolidation.

A final point, the performance and quality of NPLs which have exited banks' balance sheets but remain within the financial sector need to continue to be monitored.

Mr. Stephan:

Let me start by saying under the outgoing Prime Minister's leadership, the Italian economy has taken significant strides forward. The national unity government provided political stability, and this has helped the country grip reform and present a plan for economic recovery.

Going forward, continued structural reform implementation and investments according to Italy's national plan will be important. It will be important to secure further tranches from the EU's Next Generation facility, and there the focus should be on meeting the timetable milestones for reforms set out in this plan.

The Next Generation EU funds are important because they support the green and digital transition, and they can lift the country's trend growth. I am a bit hesitant to quote opinion pieces in my Board intervention, but I think I can make an exception with a quote from Mr. Pier Padoan, former Italian Minister for Finance and Economy and former Executive Director in the Board: "This may be a political crisis, but we must not allow it to become an economic crisis. We cannot allow current instability and further political fragmentation to derail the important plans that are in place or unwind the good work done so far." So having said this, I have faith in the Italian authorities and Italian people, and this is not the first time in history that there are early elections.

Mr. Bevilaqua:

We issued a comprehensive gray statement, and I will highlight a few issues for emphasis. Italy should be commended for posting a robust recovery from the pandemic shock, emerging from it without any significant economic or financial scarring. Nonetheless, incremental external shocks, in particular

those stemming from the war in Ukraine, have been forceful and could dent recent progress. Moreover, the Italian economy could still face challenges related to the strength of trend growth and debt sustainability. As expected, after rebounding in 2021, growth will moderate, but it is still projected to remain at a robust 3 percent in 2022, even after accounting for the effects of the war in Ukraine and the tightening of financial conditions. Indeed, among G7 economies, Italy is the only that had growth projections revised up in the recent WEO update. Over the next five years however, staff projects growth to remain below 1 percent on average, while the authorities are more sanguine about the results from the implementation of the NRRP. The NRRP not only is expected to boost demand in the short-term but, most importantly, to remove supply bottlenecks and crowd in private investment, enhancing potential growth over the medium term.

As elsewhere in the globe, Italy has witnessed a steep increase in inflation. An effective response from the ECB is needed to decisively fight inflation in the Euro Area, avoiding a price wage spiral. In this regard, we applaud the recent, albeit belated, step taken by the ECB to finally, start moving the monetary stance in the right direction. We acknowledge that in the near future, a favorable debt dynamic will continue to reduce the debt burden as new issuances continue to carry lower interest than retiring ones. Yet, that virtuous process is set to fade away relatively soon, and therefore, it is very important that the authorities pursue a fiscal stance that delivers a primary balance that stands capable of generating significant surpluses over time to help ensure a downward path for Italy's high public debt. Given the increasing risks faced by European authorities regarding energy supply, we take positive note of the authorities' efforts to diversify oil and gas supplies while easing restrictions to enact greenfield investment in renewables. We also commend the authorities' initiatives in sharing windfall gains to lower prices for end users in a way that does not preclude the signaling from energy prices for a more efficient allocation of resources. Furthermore, we welcome the sound performance and resilience of the financial sector with the banking sector showing improved profitability, robust capital, and low NPL ratio. As the global economic situation evolves towards a period of lower growth and tighter financial conditions, and with pandemic-related measures being unwound, close monitoring is warranted.

Finally, we commend the authorities for their steps to strengthen the effectiveness of the AML/CFT framework and the establishment last June of the register of beneficial owners.

Mr. Jennings:

We have issued a comprehensive gray statement, so I will keep my comments brief.

First, we agree with Mr. Poso, who highlighted in his gray statement that policies over the medium-term should be aimed at achieving prudent fiscal positions and ensuring debt reduction through gradual consolidation in the context of a credible and well-designed multiyear fiscal strategy.

Second, we positively note that the Italian banking sector has further stabilized since the start of the pandemic and should be able to weather shocks and the tightening of global financial conditions. However, elevated and rising uncertainty remains as staff analysis suggests that rising interest rates in the context of high public debt and weak growth may result in adverse feedback channels.

Finally, like Mr. Hilbers and Mr. Buisse in their gray statements, we encourage the authorities to make further progress on the climate transition, including by simplifying the approval process for renewable energy projects and unlocking investment in this sector.

Mr. Mizuguchi:

We welcome the Italian economy's rebound from the pandemic and upward revision of the 2022 growth outlook in the WEO update, thanks to the authorities' appropriate policy measures. At the same time, Italy faces a number of challenges due to the spillovers from the Russian war against Ukraine and the possible uncertainty arising from the recent political developments. We issued a comprehensive gray statement, so I will limit my comments to the following three.

First, on the fiscal policy, we welcome the fiscal deficit and debt ratio have declined in 2022, and we agree with staff that the faster adjustment could be considered given the high inflationary pressures. Support measures to mitigate the impact of elevated energy prices to the vulnerable should be temporary and well-targeted. In the medium-term, comprehensive fiscal reform is vital to achieve the primary surplus of 2 percent of GDP no later than 2030, including broadening the tax base, comprehensive review of the budget, prioritization of spending to support long-term growth and social inclusion.

We note that the recent political developments could cause delays in budgeting approval and the delivery of reforms on the NRRP and thus may heighten policy uncertainty with potential medium- to long-term effects. We encourage staff to closely monitor these developments and their implications on the Italian economy and the financial markets.

Second, it is urgent to address energy security while pursuing climate change goals. The government's efforts to secure alternative energy supplies are becoming more important and shifting toward more targeted measures with price signals would enhance energy efficiency and conservation. At the same time, authorities needed to continue to pursue decarbonization to achieve the Fit for 55 targets. In this vein, it will be necessary to enhance carbon taxes and green investment incentives in an effective manner while maintaining Italy's competitiveness at the same time.

Finally, it is necessary to improve Italy's productivity by accelerating efforts to enhance human capital and infrastructure. We note the labor force participation, especially for women and the young, and agree that the full and timely implementation of NRRP reforms could help.

Mr. Hosseini:

We have issued a gray statement, but I would like to highlight a few issues briefly.

First, we thank the authorities for the swift and proportional policy response and a successful vaccination campaign that rebounded the economy sharply in 2021 and put it on track in early 2022 before it lost some momentum due to the spillovers from the war in Ukraine and more recently because of uncertainties related to the current political impasse.

The surge in energy prices has had a profound impact on Italy. Second, Italy is largely dependent on imported energy, and one of its key challenge is to address its energy security issues both in the near-term, as well as over the longer-term. Members of our constituency have increased energy supplies to Italy to alleviate its import shortage.

Third, it is important to get growth back on track. The NRRP is expected to provide a significant boost to output by supporting demand in the short run and addressing supply constraints in the longer-term. It is very encouraging that all the NRRP targets have been met so far and that the authorities are committed to its full implementation. The NRRP is a strong

start to a comprehensive longer-term strategy that is needed to lift Italy's lagging productivity and green its economy.

Fourth, the Italian financial sector proved its resilience and emerged from the crisis with no apparent scarring. NPLs are low, and new NPLs have even marginally declined in relation to loans, per Mr. Fanizza's buff statement. We also note that unlike most other major advanced economies, there is no real estate market bubble to be concerned about. These are very important developments.

Fifth, the budget overperformed during the first half of the year despite higher spending to protect the vulnerable groups. As suggested by staff, revenue from taxing windfall, profits of energy companies should be used to alleviate the higher cost of energy on household and firms in a targeted and budget-neutral manner.

Finally, although the public debt ratio is very high, we believe there are no debt sustainability issues. The authorities are committed to generating annual primary budget surpluses over the medium-term to ensure that the debt ratio remains on a steep downward path. Also, the average cost of debt is declining, and debt maturities are lengthening, as new longer-term issues will be replacing higher, cost short-term debt.

Mr. Alrashed:

We have issued a gray statement and would like to underscore a couple of points.

First, we commend the authorities for their decisive fiscal policy response, which supported the economic recovery from the pandemic while reducing fiscal deficit and debt ratios. Nevertheless, placing public debt on a firm downward trajectory over the medium term remains the key priority. Therefore, we agree with staff on the need to advance fiscal reform efforts to improve tax compliance and broaden the tax base, as well as improving spending efficiency and restraining recurrent spending growth. These reforms are critical to balance fiscal consolidation goals with the need to protect priority investment and social spending.

Finally, we welcome the progress on the implementation of NRRP, and we encourage the authorities to continue with the timely implementation of these reforms.

On climate, we agree with the authorities that relying on carbon taxation at this stage is not practical given the already high domestic energy tax and lack of EU coordinated approach. Most importantly, rising energy security threats and inflationary pressures poses significant risk on the domestic and regional macroeconomic stability and growth prospects. We therefore underscore the importance of tailoring and appropriately timing staff advice on climate mitigation based on the country circumstances and regional context.

Mr. Hilbers:

We have associated ourselves with Mr. Poso's statement, and we have issued a comprehensive gray statement, so let me just make a few remarks today. First, on fiscal, it is important to reconcile immediate policy priorities with fiscal sustainability. After the bold and effective policy response that contributed to the remarkable rebound of the Italian economy after the pandemic, the authorities are now confronted with a difficult dual task limiting the spillovers of Russia's war in Ukraine and ensuring fiscal sustainability. This includes securing energy supplies and developing contingency plans that would provide temporary, targeted, and affordable support in the case of a Russian gas shutoff, while at the same time staying committed to the growth-friendly fiscal consolidation. In this context, like Ms. Medearis, we appreciate staff's analysis of the war spillovers and encourage continuous policy dialogue that would aid complex policy decisions.

My second point, brought up also by Mr. Moreno and others, that lifting potential growth—is a key issue in this context—is paramount not just in boosting the overall resilience of the Italian economy but also in keeping the high public debt ratio on a firm declining path. This is confirmed by staff's analysis, which shows high sensitivity of the required fiscal consolidation efforts to the medium-term growth path. In this context, we applaud the authorities for the effective implementation of their well-designed recovery and resilience plan, the NRRP. We hope the authorities will manage to keep the reform momentum despite the current challenging political landscape.

Third, while we welcome previous decarbonization efforts, we see a scope for accelerating the green transition, which would allow achieving climate targets. We share staff's view that energy security and sustainability efforts should reinforce one another over the long-term and that higher fossil fuel prices can be a catalyst for faster deployment of renewables and deeper improvements in energy efficiency, and therefore we encourage the authorities to unlock green investment, especially in renewables.

Finally, like Mr. Huh, Ms. Lim, we commend the authorities for implementing the 2020 FSAP recommendations, which improved the financial sector resilience, as Mr. Fanizza also noted.

Mr. Sylla:

We have issued a statement but would like to make a few brief remarks for emphasis.

First, we welcome Italy's strong recovery from the pandemic but recognize that the country is facing significant policy challenges as a result of the geopolitical tensions and global inflation. We note Mr. Fanizza's reassuring remarks on the political situation, but we also note from the staff responses that the political crisis may delay implementation of needed reforms and investment in the current challenging circumstances and ultimately affect public finances during the semester. This suggests that there may be divergence across the political spectrum on regional policy orientation. Could staff elaborate more on this? What are the main policy divergences in public discourse? Also, to which extent the resignation of Prime Minister Draghi has already affected the macroeconomic projections?

Finally, sustaining reform momentum and pace of investment under RRP will be critical to increase potential growth, ameliorate productivity, and support green transition. This point has been highlighted by many of my colleagues. We look forward to continued progress in those fronts despite the challenging environment.

Ms. Lim:

We issued a comprehensive gray statement with Mr. Huh, so I will be brief.

First, on fiscal sustainability, we thank staff for the response to our question on the risk perception for Italy, as well as the explanation on the impact of the ECB Transmission Protection Instrument and potential assistance in mitigating deteriorating financial conditions. We would like to stress the importance of ensuring the downward debt trajectory, as recommended by staff, through continuing good efforts on fiscal discipline and for authorities to remain committed to structural reforms to boost the country's potential growth and competitiveness. Against the backdrop of rising financial costs and elevated public debt, policy continuity on these key

areas will be necessary to bolster investor confidence, especially in the time of political uncertainty.

Second, on financial stability, we appreciate that rising interest rate is benefitting the banking sector's profitability, but this could easily drift the other way around, especially in conjunction with the worsening economic outlook and the potential adverse impact on public balance sheets, inevitably affecting the health of both banks and nonbanks. Hence, we think close monitoring is warranted. Banks and, in fact, the whole financial sector, should be prepared for severe downside risks.

Mr. Palotai:

We have issued a gray statement, and we associate ourselves with Mr. Poso's statement, so I will be brief and offer three comments for emphasis on debt level, on structural reforms, and on policies to address urgent climate needs.

First, Italy's debt-to-GDP level remains too high and demands assertive policy responses and the authorities' full commitment in the medium-term. Like Mr. Stephan in his gray statement, we think that market confidence should be underpinned by good domestic policies, and the primary surplus goal of 2 percent to be reached by 2030 could be more ambitious. Nevertheless, we acknowledge and appreciate the authorities' attention and commitment to addressing this issue. Reducing the debt burden and debt servicing cost will help Italy free up fiscal space in the medium term and make the economy more resilient to shocks.

Second, the authorities need to focus on deep and structural reforms which in the past have been kicked down the road. This will include making the pension system sustainable through meaningful reforms, broadening the tax base, promoting competition to lift the growth potential, and an enabling environment for private-sector development and investments. The previous administration started with implementing important structural reforms in the context of Next Generation EU (NGEU), which the next administration should absolutely continue.

Third, we note that considerable efforts have already been made to decarbonize the economy and to meet Italy's climate goals but further steps could result in quick gains such as further streamlining approval procedures for pending projects in renewable electricity capacity development. This is now less critical also for energy security. If done right, moving faster on

carbon taxation is per se not detrimental to competitiveness, as the example of Sweden shows.

Mr. Alhosani:

We issued a statement with Ms. Mannathoko, and I would like to emphasize a couple of points, first, broadly on the economic developments and then on energy security and climate.

Italy's effective policy response to the pandemic and related shocks helped avert a worse scenario, and we welcome the strong economic rebound as a result. Nevertheless, risks to the outlook are tilted to the downside amid high uncertainty, which underscores the importance of maintaining prudent and flexible policymaking. As highlighted by many Directors, the renewed commitment to steadfast implementation of the NRRP, as said in Mr. Fanizza's buff, is welcome, as it will provide a significant boost to Italy's economic performance and help sustain this performance in the face of new shocks.

On climate and energy security, we take positive note of the progress made by the authorities in reducing emissions since 2000. We also welcome the measures taken to improve efficiency and cost effectiveness of green investments. Along with their mitigation efforts, we encourage the authorities to accelerate climate adaptation efforts, as we all continue to address the issue of energy security. We see merit in the authorities' views that reduction of carbon emissions through fiscal measures requires an EU-coordinated approach. Furthermore, like Mr. Alrashed, we agree that additional taxation on energy at the current juncture will further fuel inflationary pressures with adverse impact on vulnerable households, as low-income households tend to consume a more energy-intensive basket.

Mr. Mozhin:

I have a couple of points to make.

It is very sad that perhaps the most beautiful country on earth is in such deep trouble, both economically and politically. There has been 20 years of effectively no growth. Living standards are now below what they were 20 years ago, at least according to some measures, and the real question is how Italy can avoid another 20 years of no growth and deterioration in living standards. The report is very clear on that. What Italy needs, they need debt reduction; and to achieve debt reduction, it needs structural reforms that

would allow to enhance growth and by higher growth to grow for the economy to grow out of this very high level of public debt.

It is rather amazing how the long sequence of Italian governments have failed to cope with taxi drivers and other mafias of so-called closed professions. Anybody who visited Italy must know that one cannot get a taxi by simply raising one's hand on the street. One needs to find a way to some place where they accumulate, and the purpose of that is really to deny any competition between taxi drivers so that they all get the same level of income. So structural reforms are absolutely needed, and that is the only way how public debt reduction can be achieved on a permanent basis.

The only other point I want to make is on my favorite subject, which is gas deliveries from Russia to Europe. I made this point on the discussion of Germany, but after listening to staff, I feel that I need to repeat all those points. What is happening in this sector is a chaos, a chaos created by the European authorities and nobody else. One story is well-known, and that is the story of the turbine, which was sent a long time ago, was sent to Siemens, the German company Siemens, for maintenance and repair. Eventually it was sent to the Siemens plant in Canada, and then the Canadian authorities refused to return it back to Germany; and now it is in Germany, but it has not been delivered to Russia, to Gazprom. And when Gazprom attempted to find out where this turbine is located, the answer was we cannot tell you because this is a secret. That is on top of other things, like two pipelines running through Ukraine. One is closed for no reason at all, and the European authorities have not even attempted to prevent this from happening. The big pipeline, which is called the Yamal pipeline, which runs through the territory of Belarus into Poland and then Germany, this pipeline is now working in a reverse mode of the Russian gas received by Germany through Nord Stream 1 pipeline shipped back to Poland. There are benefits, of course, financial benefits, from both Germany and Poland from this because Germany receives gas under the long-term contract at the low price, and they sell it to Poland with a markup, but the alternative for Poland would be to buy even more expensively at the spot prices, which have skyrocketed. I understand the benefits, but, of course, this is preventing the delivery of gas to Europe.

On top of that, there is this Nord Stream 2, brand-new, ready-to-be-exploited new pipeline, which cannot be used for entirely political reasons. This is chaos, and the patience on the Russian side is really growing very thin. Why do not you tell us, either you want the Russian gas or you do not? And if you do not, we just forget about the whole issue.

Mr. Zhang:

The Italian economy has rebounded strongly after the pandemic but is now facing new challenges. We hope the upcoming new government could swiftly through political consensus to carry out much-needed reforms, continue to support the regional economic and financial integration and make contribution to global stability.

To reduce the debt-to-GDP ratio, we believe more focus should be given to the growth denominator side. While gradual consolidation is needed, fiscal sustainability should be achieved more by lifting potential growth through investments and reforms. The authorities' steadfast implementation of the NRRP is of great importance in this regard. The surge in fuel prices and heat waves across Europe make the green transition more urgent than ever. We support the authorities' efforts to unlock investment into renewables. Further simplifying procedures for investment projects and removing non-tariff trade barriers on basic materials would help to lower the cost of such energy transition.

Regarding the carbon taxation, we agree an EU-coordinated approach is needed, but a global coordinated approach is more important. We reiterate the unilateral movement of carbon border adjustment mechanism may cause unintended consequences and should not become a prerequisite.

Mr. Huh:

As we issued a comprehensive gray statement with Ms. Lim, I would like to offer two brief points.

First, we believe NRRP is instrumental to implement necessary reforms to overcome longstanding structural weaknesses such as level of productivity, as well as to bolster investment, especially in the area of climate change, digital technology, and human capital. We appreciate the authorities' strong commitment to reform agenda as expressed in the buff statement. However, we are just concerned about the possibility the recent political developments may pose some challenges for timely implementation of structural reforms, thereby resulting in delays for Italy to assess the EU Fund. We hope the Italian authorities continue to keep strong momentum for the structural reforms.

Second, we note from the buff statement the Italian authorities' position on carbon taxation. It appears to show the authorities' concern on

industry competitiveness with respect to carbon taxation. We believe that global cooperation is needed to find a global solution that has to be consistent with the WTO rules and the Paris Agreement.

Mr. Westphal:

We issued a comprehensive gray statement, so I will just make a few points for emphasis. First, we welcome Italy's recent strong economic performance, including that GDP has recovered to pre-pandemic levels, but as many other Directors have pointed out, risks are tilted to the downside going forward including with the potential for a shutoff of Russian gas. We appreciate staff's in-depth discussion of this risk for a variety of countries recently, including for Italy, in the staff report. We also note that the risks that staff euphemistically described as a potential lack of policy continuity have unfortunately now materialized in Italy. We appreciate staff's clarification in their responses to technical questions and Mr. Fanizza's clarification this morning about the consequences of the change in government for economic policymaking and the budgeting process near-term.

We agree that in light of Italy's high debt and rising financing costs, the new authorities will need to clearly commit to pursuing medium-term fiscal consolidation. In response to high energy prices, we agree that they should pass on costs to end users and target energy support measures to vulnerable firms and households rather than implement across-the-board cuts in taxes and fees. We also encourage the authorities to follow through on their climate and decarbonization goals even as they attempt to balance energy security and affordability in the wake of Russia's invasion of Ukraine. We agree with many others that it will be crucial for the new government to act swiftly and prioritize reforms under the NRRP to avoid a delay in disbursement of EU recovery funds and minimize the potential for negative impact reaction.

Mr. Roman:

We issued a gray statement, and I associate also with Mr. Poso's statement, so I will only make three short points for emphasis.

First, I would like to highlight the very effective policy response of the Italian authorities since the start of the pandemic, which enabled a strong rebound in economic activity. All European countries are unfortunately now confronted with a worsening outlook and difficult policy tradeoffs. It is true that the political situation in Italy is a new challenge, but I encourage the

current and future Italian authorities to make the best choices and continue to advance on our common priorities.

Second, on the fiscal front, let me also insist on the significant improvement in the fiscal projections with primary surpluses now expected by 2025, together with a sharp reduction in the public debt ratio. Of course, as everywhere, measures need to be more targeted to vulnerable households, and a careful calibration between fiscal consolidation and public support will be warranted in case of a larger-than-expected slowdown in economic activity.

Regarding the long-term fiscal situation, in our view the key is to support long-term growth and productivity through continued structural reforms and investment, so I very much agree with the emphasis on growth in Mr. Fanizza's intervention. It is exactly the first point that was emphasized by Ms. Laurence Boone in the interview she gave last Monday.

Lastly on this topic, we agree with both staff and the authorities on the very important role played by the NRRP and the NGEU financing.

Third, more specifically on climate, I fully support the call for an increase in green investment and the improvement in carbon taxation. Italy has made quite significant progress in reducing emissions and improved energy efficiency, but more is needed to meet climate goals. On the investment part, this is again very much linked with NRRP and EU financing. It is a great opportunity to advance swiftly in the right direction.

Mr. Lischinsky:

We have issued a comprehensive gray statement and will mention some issues for emphasis.

After a freefall due to COVID-19 in 2020, Italy has fully recovered, and the GDP has increased over the pre-pandemic level in 2021. In this regard, the good GDP performance observed in 2021 would moderate in 2022 due to high energy prices and energy security costs by the war in Ukraine and gas dependency, as well as international food price increases that were aggravated in Italy by fires and a severe drought, which have to be added to monetary policy normalization from major central banks. To deal with uncertainty, fiscal buffers need to be increased, and the public-debt-to-GDP ratio can be diminished, and for that to be possible, the average economic growth rate of 0.8 percent seen in the period 2014 to 2019 has to be doubled.

We commend the authorities' efforts to fully implement the reform and investment plans under the NRRP, which is key to increase potential growth, address long-term vulnerabilities, and safeguard key macroeconomic variables and consumer and investors' confidence. Taking into consideration the findings in the Selected Issues Paper on productivity in Italy, it seems advisable for the authorities to follow a multi-policy approach to improve labor productivity at the regional and sectoral levels to lift it to the level of peer European countries. Hence, increasing productivity and growth would facilitate an ambitious primary fiscal surplus that would secure a greater reduction of the public-debt-to-GDP ratio to pre-COVID levels by the end of the decade or before because 33 percent of the recent debt increases due to the pandemic would be reduced by the end of this year. This will be a much better performance than the rest of G7 countries with large debt increases during this period.

The banking sector entered 2020 on a better footing to accommodate the shock from the COVID-19 pandemic and, more recently, the potential spillover from the war in Ukraine. The banks have started to distribute dividends and at the same time have increased capital and liquidity buffers. As Mr. Fanizza said, NPLs are declining, as is the flow of new NPLs. We also highlight that the Bank of Italy's supervision has reduced risk and improved the capitalization of a small and medium-sized banks, which is very important because they serve the small and medium firms.

Mr. Moreno:

I associate myself with Ms. Marcussen's remarks. I guess Mr. Mozhin is not here. I do not share his sadness and his pessimism. We are talking about a more positive scenario in Italy, and that is the general message; very effective response to the crisis, stronger growth than expected, sounder fiscal position, even after spending measures to alleviate the higher energy prices and also thanks to sounder public debt management, protection of the most vulnerable, sounder financial sector, and accelerated reform agenda that is underpinned by the Recovery and Resilience Plan, which is also anchored by the Next Generation EU Fund.

There is always need for vigilance. In the case of Italy, we have the uncertainty linked to Russia's war on Ukraine, but we also have the political uncertainty, although I think as Mr. Stephan was mentioning, this is not the first time that Italy is under these circumstances, so they are used to managing it. I think what is important here is what Mr. Fanizza mentioned at the beginning. We need to keep the reform agenda. He mentioned that the trend of

the reforms were ongoing, and hopefully it will not be reverted. That is the main objective and the emphasis on growth and output, which many other colleagues have emphasized is what we would emphasize as well.

Among the other reforms, I think the staff is pointed in the right direction. Fiscal policy has to remain flexible in the short-term and look for consolidation in the medium-term. Increasing output growth, maybe more revenue mobilization; and I would also highlight here the need to look at the new European Union fiscal rules because we all go together on this road. On the financial sector, we need monitoring of the most vulnerable sectors.

Finally, on the structural reforms, I will emphasize climate, like many other colleagues. We should not forget about climate, including carbon pricing, when the time comes. Here again there is a need to do EU coordination.

Ms. Mannathoko:

We issued a joint gray statement with Mr. Mohieldin and Mr. Alhosani, so I will limit my intervention.

While we commend the authorities' robust effectiveness response to the significant shock from the pandemic—this was also noted by Mr. Roman—nevertheless, downside risks from the spillovers from the war, drought conditions in the north, high public debt, and tightening financial conditions, as well as the recent political developments, all of these do present new challenges; so I wanted to join others in encouraging the authorities to prioritize difficult reforms needed to contain public debt while at the same time reforms to enhance productivity and GDP growth. Timely implementation of an effective medium-term fiscal strategy is important.

Sustained, successful, and timely implementation of the NRRP is also essential, so we are really glad to hear that reforms will likely continue through September elections notwithstanding political developments. We are also reassured by staff's and Mr. Fanizza's response and really want to encourage efforts to sustain this momentum, you know, keeping the train running. As Mr. Fanizza indicated, implementing the NRRP and important fiscal measures, including also just trying to keep the timeline on the 2022 budget approval.

We thank staff for the response to our question on coordinated EU action on carbon emissions and just wanted to take this opportunity really to

encourage the EU to lead global action, accelerating the Fit for 55 package implementation to operationalize emission reduction targets set out in the climate clause but also to the extent possible while ensuring energy security but also enabling a mutually reinforcing outcome, as noted by Mr. Ronicle and Mr. Hilbers. An aggressive green energy investment drive will clearly help in ensuring decarbonization targets are met within a coordinated framework.

Ms. Riach:

I want to make a few points, most of which I think have been covered by others. It was really helpful to hear Mr. Fanizza's remarks at the beginning about the political situation because it is a concern—it is the same situation in my own country—when we face such political turbulence at a time that is already very challenging for European economies, but it was reassuring to hear what Mr. Fanizza said about the functions of the government that will continue and in this interim period, and particularly the fact that he sets out the implementation of the NRRP will continue, because that is very important in order to keep progress on the reform that has already been made and also to ensure that the NGEU recovery finance continues to come on track.

On public debt, we join others in welcoming the authorities' commitment to lowering the deficit and debt ratios. The high public debt ratio is a longstanding concern for Italy, and like all of us, this situation was exacerbated by the COVID crisis and by the very good action and response that the Italian authorities took to that crisis; but given where we are and the rising borrowing costs, we think that the authorities' commitment towards lowering the debt ratio and the deficit is important, and we encourage them to continue to focus on that, so we support the move towards more targeting of fiscal measures to support the most vulnerable and to address higher energy prices driven by Russia's war in Ukraine. We share staff's view that keeping debt-to-GDP on a downward path will require faster GDP growth, and I welcome the emphasis on this that Mr. Fanizza had in his remarks today.

On climate, we commend the authorities for the significant action that is being taken today. Italy, like all European countries, is now faced with difficult short-term choices between balancing energy security and decarbonization efforts in the face of the spillover impacts from Russia's war in Ukraine. We welcome staff's discussion of tradeoffs and policy options, including the helpful staff issues paper. In the longer-term, higher fossil fuel prices can be a catalyst for faster deployment of renewables and deeper

improvements in energy efficiency, but that does not alter the fact that in the short-term some difficult choices will have to be made.

Mr. Peter:

I would like to add two brief comments on substance and one on procedure.

First, like several other colleagues, we are concerned about the current government crisis in Italy and especially its implications for the implementation of important reform and investment plans. The coalition government brought an impetus for much needed reforms to rekindle Italy's growth. This task implies substantial work ahead, and the country cannot afford prolonged political instability. Delaying or weakening the structural reform agenda will have implications for the authorities' plan to durably lift potential growth, which is a central part of the strategy to keep public debt on a firmly declining path over the longer-term, as also emphasized by Mr. Hilbers. We hope that in the coming months, the current political impasse can be resolved and the momentum for reform and debt reduction resumed.

Second, I would like to fully associate myself with the comments made by Mr. Palotai just before.

Mr. Bhalla:

We have issued a gray statement, so just some very brief comments.

Italy's recovery is suggestive of several divergence from conventional wisdom. Briefly, it has the same inflation rate as the rest of Europe but with a much-reduced fiscal deficit. Maybe fiscal deficits do not cause inflation or help reduce inflation.

Regarding political uncertainty, Italy has been there many times before and does not seem to suffer adversely from it, and we do support the view of the authorities that it is a bit difficult for Italy to consider a carbon tax without a coordinated EU approach.

The staff representative from the European Department (Ms. Van Elkan):

There were a couple of questions about implications of the recent political developments. One question was to what extent or how macro projections would change by the recent political developments. First, as we

indicated in our written responses, we had highlighted these in the risks. However, just to note that, whether it was serendipitous or not, when we were finalizing the staff report, the interest rates in Europe were particularly high, and they have since come down, so to some extent, we have already anticipated some of the pickup in interest rates as a response to the increased political uncertainty, so that is there.

Another thing to note is that on the growth forecasts, there was a lot of temptation at the time when the NRRP was first announced to build in the future impact into growth forecasts. We resisted that temptation, therefore, we do not need to be concerned that anything less than full implementation would alter our forecasts. But, of course, when implementation does happen, we will revise our forecasts.

There was a second question on policy divergences within Italy. Different political parties have different priorities. One area of note is on social spending programs, and this goes back to the need for improving potential growth because the focus on social spending programs is definitely addressing a need that is there, which is social exclusion, and the high number of households at risk, but this is very much focusing on the symptom. It is important therefore to increase living standards, increase growth potential, so that fiscal policy does not need to keep providing sizeable social transfers for that purpose.

Let me also make a point about policy continuity. I am very glad to hear that there is under this caretaker government the potential for continuation of policies, implementation of the NRRP. It is also fair to say that there are incentives going forward beyond this transition. The policy framework from the NRRP but also now this new instrument by the ECB is providing policy guardrails. If one wants to move outside those guardrails, it is still possible to do so, but there is considerable incentive to stay within those guardrails and stay on the path of prudent policies, and we hope that this will be continued by the next government.

Mr. Fanizza:

I would like to thank my colleagues for their support and for their inputs and staff again for an excellent job.

Let me just say following up on what Ms. van Elkan was saying: that we found a way to push things through. We thought that the crisis was difficult, but the government found a way to transform the crisis into

opportunity. Thanks to the Directors for their support and inputs that I will duly relay to my authorities.

The Acting Chair (Ms. Gopinath):

Italy is an Article VIII member, and no decision is proposed. The 2022 Article IV Consultation with Italy is hereby concluded.

The Acting Chair (Ms. Gopinath) adjourned the discussion.

ANNEX

- Gray Statements
- European Central Bank Statement
- Staff's Responses to Executive Directors' Technical Questions
- Constituency Codes

Statement by Mr. Fanizza on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the insightful and well-written papers that are rightly focused on Italy's current main policy challenges: (a) minimizing the economic impact of Russia's aggression against Ukraine; and (b) maximizing the impact of the National Recovery and Resilience Plan (NRRP) on potential growth. My authorities' comprehensive policy response has helped the economy rebound from the pandemic-induced slump. The authorities have also started to address long-standing structural challenges in the context of the NRRP. No doubt much work is still needed, but they are off to a good start. The country's recent economic resilience suggests that continuing these efforts will yield substantial payoffs.

1. The Post-pandemic Recovery and the Outlook

The pandemic hit Italy early and hard. In response, the authorities took strict measures to limit mobility and, as a result, economic activity came to a halt. **The rebound has so far been way stronger than expected.** The country's economic resilience has, indeed, been remarkable; the policy response has proved quite effective. The war has made for a gloomier outlook for the rest of this year and the next one, but economic activity in Italy has continued to move at a brisk clip, despite the surge in inflation and the slowdown in global growth. In fact, the latest WEO Update has just revised upward its growth projection for 2022 – the only upward revision among G7 countries. Nevertheless, we do agree that the outlook for the next year has worsened because of: (a) the increasing likelihood of a gas shut-off by Russia; and (b) the tightening of global financial conditions, as a result of the central banks' efforts to bring inflation back to targets. The authorities have already reduced Italy's dependence on Russian gas by diversifying supply sources and simplifying procedures for investments in renewable energies. **A much-strengthened financial sector should withstand the adverse impact of tighter financial conditions,** and even possibly benefit from higher interest rates. Similarly, still declining average debt costs and a long average debt maturity would contain the impact on public finances. Thus, the authorities are more sanguine than staff on the growth outlook for 2023, also because of the favorable demand impact from the implementation of the NRRP.

2. Public Finances

Like elsewhere, the pandemic caused a step increase in the public debt-to-GDP ratio (21 percentage points) that reached 155 percent in 2020, no doubt a high level. However, staff project that 36 percent of this increase will be reverted by the end of this year, much sooner than expected only a few months ago. **This performance compares favorably with those of the other G7 countries** that experienced even larger percentage step increases. We believe these dynamics augur well for further reducing Italy's public debt burden. Indeed, under the baseline scenario, staff project further sizable reductions over the medium-term horizon. **The public finance position has indeed strengthened.** Buoyant revenue

performance and strict expenditure control have improved the primary balance, despite additional temporary spending to shelter households and firms from the spike in energy prices. These efforts will continue over the medium term, with the objective of bringing the debt-to-GDP ratio, gradually, to its pre-pandemic level by 2030. Over the longer term, we believe raising trend-output growth will be essential to lower the debt burden.

It is reassuring that staff acknowledge that the authorities' budgetary projections have a conservative bias with, **often, better-than-budgeted outcomes**. Thus, we believe there are good chances that the 2022 fiscal outcome could be in line with staff's recommendation to save part of the revenue overperformance. Looking forward, the fiscal adjustment path will have to comply with the EU fiscal rules, when they resume. We believe that suspension of the existing fiscal rules should continue until new rules are agreed upon.

Public-sector financing requirements have remained substantial, but **are declining and projected to reach pre-pandemic levels in 2023**. The average debt cost is projected to decline at least until 2025, even under pessimistic assumptions on borrowing costs, as new issues replace maturing high interest-bearing securities. Moreover, the ECB has committed to roll over its holdings that come to maturity. Overall, financial conditions for placing Italian debt appear favorable. Increases in secondary market spreads appear to have reflected more domestic political noises than fundamentals.

3. Financial Sector

The Italian banking sector has strengthened since the start of the pandemic. Capital and liquidity buffers have significantly risen, despite banks resumed dividends' distribution: (a) **the stock of outstanding gross NPLs has continued to decline to reach about 3 percent** of total loans; and (b) the flows of new NPLs have dropped to only 1 percent of loans. Both households and corporations maintain large liquidity buffers against rising prices and interest rates that should cushion the impact of tighter financial conditions on both consumption and investment.

Banks' profitability has improved with higher returns on equity, reflecting mainly reductions in fixed costs. The impact on banks' profitability from the expected rise in interest rates should be favorable overall. The expected increase in net interest income should more than offset the amount of additional loan-loss provisions necessary to deal with a possible rise in NPLs over the medium term. Bank of Italy estimates a quite limited reduction in capital buffers as a result of the impact of higher interest rates on the market value of banks' holdings of fixed-income securities. There is no evidence suggesting a deterioration of the quality of loans previously subject to moratoria or under public guarantees.

Nevertheless, we agree with staff that a cautious approach to bank capital is needed; pre-emptively restricting dividends distributions could be considered on a case-by-case basis, depending on individual banks' capacity to withstand a severe and protracted economic downturn.

Progress has been made on numerous key recommendations from Italy's 2020 Financial Sector Assessment Program (FSAP), including on credit risk analysis for less-significant banks, loan classification and NPL provisioning practices, and the macro prudential framework.

Small- and medium-sized banks that fall under the supervision of the Bank of Italy have reduced risks and improved their capitalization, as a result of a pro-active and preemptive supervision approach, which identified remedial measures to improve the position of the most fragile intermediaries.

4. Structural Priorities

The authorities reiterate their commitment to a steadfast implementation of the NRRP that will provide a significant boost to Italy's economic performance, by supporting domestic demand in the short-term, and more importantly, lifting supply constraints over the medium-term to boost potential growth. Moreover, making the best use of the EU Recovery and Resilience Facility (RRF) funds will help close the public investment gap, which will lift potential output and crowd in private investment. **So far, all the NRRP-envisaged targets have been met.**

We wish to point out that projects that support the ecological transition absorb most of the NRRP's resources. **Staff rightly note Italy has made substantial progress in reducing Green House Gas (GHG) emissions**, but less in lowering GHG intensity of production in comparison with other European countries. However, all the countries included in the comparison still rely on nuclear power generation that has been banned in Italy since 1987.

We agree that a carbon tax would help achieve Italy's "Fit for 55" target, as suggested by staff. However, **to be effective, carbon taxation should be implemented only in the context of an EU coordinated approach that includes a Carbon Border Adjustment Mechanism**, building on the successful experience of the European Emissions Trading System (ETS). We would have welcomed staff's input on "second-best" policies that could be followed in the absence of an EU coordinated approach, particularly considering the already quite high level of energy taxation in Italy.

5. Conclusions

During the last year, policies have managed to successfully balance, on the one hand, the need to reduce the public-debt burden with, on the other hand, supporting the pandemic recovery and containing the adverse impact of high energy prices and inflation on the weakest population. **The financial sector has worked well to sustain the recovery and is now in a much stronger condition, which should help withstand adverse shocks.** Moreover, the authorities have laid down the groundwork to implement the NRRP that should help improve productivity growth and address long-term vulnerabilities.

No doubt, a gas shut-off by Russia would trigger a downside scenario. The authorities have already started implementing their risk-mitigation strategy that aims at severing the country dependence on Russian gas by 2024; they believe a coordinated European response would be warranted in the event this scenario materializes.

**Statement by Mr. Chodos, Mr. Lischinsky, and Mr. Corvalan Mendoza on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for the informative set of reports on Italy and Mr. Fanizza for his comprehensive Buff statement.

After a huge fall due to COVID-19 in 2020, Italy has fully recovered, and the GDP has risen over the pre-pandemic level in 2021. However, fiscal buffers need to be replenished and the public debt-to-GDP ratio needs to diminish over time; for that reason, the average economic growth rate of 0.8 percent in 2014-2019 needs to be doubled. In this regard, high energy prices and energy security due to the war in Ukraine and gas dependency, as well as international food price increases, aggravated by fires and a severe drought, added to monetary policy normalization from major central banks, are denting economic growth in Italy, which would moderate sharply in 2022 compared to the good performance observed in 2021.

We commend the authorities' efforts to fully implement the related investment and reform plans under the *National Recovery and Resilience Plan (NRRP)*, which according to the report and the Buff statement, could increase potential growth over $\frac{3}{4}$ percent, address long-term vulnerabilities, and is necessary to safeguard key macroeconomic variables and consumer and investors' confidence.

We go along with staff's advice to mitigate recurrent external shocks with temporary and well-targeted fiscal policies, considering the country's at-risk fiscal space in the context of elevated public debt. A timely and well-implemented NRRP could increase potential GDP growth and facilitate an ambitious goal to reach a primary fiscal surplus of around 2 percent of GDP, sooner rather than later, a figure that would secure a gradual reduction of public debt-to-GDP ratio to pre-COVID levels, by the end of the decade, and reaffirm market confidence in the prospects of the economy. At the same time, 36 percent of the recent debt increase due to the pandemic will be reduced by the end of this year, which is a much better performance than the rest of G7 countries with larger debt increases during this period.

In a context of monetary policy normalization from major central banks around the globe, the European Central Bank has decided to lift its benchmark deposit interest rate from negative values, back to zero as of Wednesday, July 27, 2022, for the first time since 2011. On top of that, after Prime Minister Mario Draghi's resignation, a sell-off in Italian debt heightened. *Could staff shed more light on the so called "anti-fragmentation" tool or Transmission Protection Instrument (TPI) by the ECB, which according to financial experts, aims at mitigating divergence in borrowing costs in the eurozone, especially between weakest and strongest nations and how could this benefit Italy?*

The banking sector entered 2020 on a better footing to accommodate the shock from the COVID-19 pandemic and more recently the potentials spillovers from the war in Ukraine. The banks have restarted to distribute dividends, and at the same time, capital and liquidity buffers have risen sharply. NPLs are declining, as is the flow of new NPLs. Furthermore, we welcome that banks' lending standards have tightened, and banks anticipate further tightening on increased risk perceptions. We also highlight that the Bank of Italy's supervision has reduced risks and improved the capitalization of small and medium-sized banks.

We commend the introduction of new macroprudential policy instruments to the toolkit, which can be activated as needed to reduce the buildup of systemic risk. Attention is advisable given elevated uncertainty and the sequential nature of the current shock. The rise of interest rates amid weaker growth and high public debt could potentially accelerate adverse feedback channels between the sovereign, corporates, and banks. Under this scenario, it seems appropriate to strengthen debt restructuring and insolvency processes, as highlighted by the recent FSAP.

The NRRP, supported by the Next Generation EU (NGEU) recovery package, will be instrumental to boost investments for 2021-2026. It will buttress large public programs of roughly 15 percent of GDP, as well as incentives for private investments to follow through. Thus, an important window of opportunity to strengthen confidence in the economic trajectory of the country and raising the level of productivity is open. Taking into consideration the findings in the selected issues paper “Productivity in Italy: scope for improvement”, it seems advisable for the authorities to follow a multi-faceted policy approach to improve labor productivity at the regional and sectoral levels to lift it to the level of peer EU countries. As we see it, the NRRP would become instrumental to push forward a comprehensive and concerted set of reforms, as well as public and private investments, to raise productivity and potential economic growth.

We encourage the authorities to continue with their efforts to strengthen policy frameworks, governance, transparency, data provision, and reduce the debt burden, which are necessary elements to enhance investment and support decision making.

With these comments, we wish the authorities and people of Italy every success in their future endeavors in these difficult times.

Statement by Mr. Ronicle and Ms. Andreicut on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the helpful set of reports and Mr. Fanizza for his informative buff statement.

Notwithstanding Italy's strong recovery from the pandemic, spillovers from the war in Ukraine, along with a high debt to GDP ratio and widening spreads, are clouding the outlook. Recent political developments create further uncertainty, during an already challenging time. We broadly share staff's advice around reducing debt, while prioritizing targeted and temporary support to deal with the energy crisis, and monitoring banks' asset quality and potential feedback loops between banks and the sovereign. Against the background of a severe drought in northern Italy, with spillover effects on food prices and the production of hydroelectricity, tackling climate change stands out once again as an immediate priority.

Fiscal policy, energy security and climate change

The authorities' pandemic-related measures enabled a robust recovery from COVID-19, but the high public debt ratio and the recent rise in borrowing costs put pressure on the fiscal outlook. With the bulk of pandemic-era support withdrawn, the authorities are now targeting spending on household and firm compensation for higher energy prices. We broadly support the measures implemented by the authorities to mitigate the impact of higher energy prices on the most vulnerable. At the same time, we welcome the authorities' commitment to lowering the deficit and debt ratios. This is essential given Italy's very limited fiscal space, elevated public debt and rising borrowing costs against a background of uncertain politics. As illustrated by the recent widening in spreads, the authorities may find it more challenging to reduce the public debt ratio going forward. We share staff's view that keeping debt to GDP on a downward path will require faster GDP growth and a more ambitious path for the primary surplus. We encourage the authorities to progress structural reforms, including a revenue-neutral broadening of the tax base and improvements in tax compliance. We hope that the ECB's new anti-fragmentation tool will help cap an excessive rise in borrowing costs for affected countries, including Italy, going forward.

The successful implementation of the National Recovery and Resilience Plan (NRRP) will provide a helpful boost to the authorities' fiscal efforts, increasing potential growth and helping lower the debt to GDP ratio. We welcome the NRRP milestones achieved thus far and encourage the authorities to maintain momentum. We appreciate that the current

political instability may challenge the authorities' implementation capacity. We hope the current political impasse will be resolved in the coming months. We are reassured by the authorities' commitment to implementation, as highlighted in the buff statement.

We agree with staff that balancing energy security with decarbonization efforts has become increasingly difficult in the current context of supply shutoffs and soaring prices. This is a challenge faced by many European economies in the aftermath of Russia's invasion of Ukraine and we welcome staff's discussion of trade-offs and policy options, including the analysis in the Selected Issues Paper. We agree on the importance of strengthening near-term energy security and share staff's view that energy security and sustainability efforts should reinforce one another over the long-term. Higher fossil fuel prices can be a catalyst for faster deployment of renewables and deeper improvements in energy efficiency. Recent droughts in the north of the country along with their spillovers effects once again illustrate the urgency of the climate challenge. We welcome Italy's good progress in reducing emissions but agree with staff that more efforts are needed for Italy to meet the EU "Fit for 55" targets. We appreciate staff's recommendations, including the idea of a carbon price floor, but note that the optimal domestic policy mix will have to take into developments at the EU level.

Financial sector

The Italian financial sector weathered both the COVID-19 crisis and the ongoing spillovers from the Ukraine war well, but caution is warranted given potential vulnerabilities. The banking sector remains resilient, including a high return on equity, robust capital positions and a low NPL ratio. However, some of these developments can be explained in part by favorable COVID-related accounting which is due to expire at the end of year. In addition, rising interest rates, weaker growth and high public debt pose the risk of adverse feedback effects between the sovereign, corporates and banks. This in turns warrants close supervisory monitoring and banks' own preparation for downside scenarios. We also note that the end-2021 deadline for selling state-owned bank Monte dei Paschi was missed. *We would be grateful for further information from staff, including on the implications that this has for public finances.*

Finally, we welcome the authorities' ongoing efforts to implement the recommendations of the 2020 FSAP. This includes good progress made on credit risk analysis, loan classification and NPL provisioning practices.

**Statement by Mr. Pösö on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank Staff for their clear and insightful reports in the context of Italy's Article IV consultation. We also thank Mr. Fanizza for his informative Buff statement.

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. In this context, and also taking account of Italy's high public debt and sustainability challenges, fiscal policy should be prudent and carefully designed, while standing ready to react to the evolving economic situation. Over the medium term, policies should be aimed at ensuring fiscal sustainability through a gradual, credible and growth-friendly fiscal consolidation, also with a strong emphasis on investments and reforms aimed at increasing the economy's growth potential by boosting productivity. In this respect, continuing with well-designed policies is essential for a timely and full implementation of Italy's comprehensive and well-designed Recovery and Resilience Plan (RRP)). The financial sector has improved its resilience in recent years, while the risks ahead underscore the need to retain sufficient capital buffers for potential downside risk scenarios.

Macroeconomic Developments

We broadly agree with the slowdown in growth and upward revision to inflation projected by Staff, and concur that the balance of risks to the outlook is tilted to the downside. The main downside risks to growth for the Italian and global economy have materialized over the last months, bringing the expansion underway to a sudden slowdown. Although Staff's projections and those of the EU Institutions are not directly comparable due to different cut-off dates, we broadly agree with the growth and inflation forecasts contained in the Staff report, with some nuances. In particular, we would expect a somewhat more positive evolution of the labor market, with unemployment declining further from current levels, supporting somewhat higher consumption. In any case, the growth and inflation outlook remain extremely uncertain given the headwinds from elevated energy and food prices, geopolitical risks, and the expected tightening of financial conditions. We also agree that the balance of risks is further tilted to the downside, the most tangible and immediate risk being a prolonged curtailment of gas supplies. In addition, a possible increase of the sovereign-risk premia in the context of the recent political instability and very high public debt, is also an important downside risk that could have negative consequences for the financing of the real economy.

Fiscal policies

We agree with Staff’s emphasis on ensuring fiscal sustainability through gradual consolidation, investments and reforms. The Authorities’ bold and appropriate policy support successfully limited the economic and social fallout from the pandemic, but also resulted in a large increase of already high public debt. In light of the current macroeconomic headwinds and fiscal sustainability challenges, policy should be prudent and carefully designed, while standing ready to react to the evolving economic situation. In the near term, this requires limiting the growth of nationally-financed current primary expenditure, and ensuring that support aimed at addressing the increase in energy prices is temporary and targeted at vulnerable households and industries. Measures should also be accompanied by incentives to increase energy efficiency and reduce consumption while signaling the government’s commitment to a declining deficit path. Over the medium term, policies should be aimed at achieving prudent fiscal positions, and ensuring debt reduction through gradual consolidation in the context of a credible and well-designed multi-year fiscal strategy. At the same time, fiscal sustainability should also be achieved by lifting potential growth through investments and reforms. In this regard, Italy should expand public investment in the green and digital transitions and for energy security, including by making use of the Recovery and Resilience Facility, of which a successful implementation is crucial, and of other EU Funds. Fiscal sustainability should also be reinforced through a more growth-friendly tax system, in particular by broadening the tax base, reducing taxes on labor, and increasing the efficiency of the system by reviewing effective marginal tax rates as well as by streamlining and reducing tax expenditures, also for VAT, and for environmentally harmful subsidies.

Structural policies

Italy is already delivering on its comprehensive and well-designed RRP, and its full and timely implementation, alongside complementary reforms and investments, is crucial to raise Italy’s growth potential and secure sustainability in light of existing challenges. Pre-existing vulnerabilities add to new headwinds and constitute an important risk for the Italian economy that require bold policy action. Italy’s RRP is well designed and contains many elements to address structural bottlenecks to growth, and its full and timely implementation is paramount to increase Italy’s growth potential. In this context, policy continuity will be essential to its success. The share of front-loaded reforms is very welcome and will help crowding-in additional private investments. The RRP is already delivering on reforms in the areas of criminal and civil justice, public administration, public procurement and tax administration, skills and education, and spending review. Reforms have also been adopted to strengthen the insolvency framework, and in this respect, facilitating out-of-court debt resolution mechanisms would also be important. In addition, we [] support moving towards a more decentralized wage bargaining system, which would help aligning wages with regional- and firm-productivity developments. We also welcome the attention given to decarbonization on the Italian RRP, with 70 billion EUR earmarked for investments in the green transition. Relevant measures in this front also relate, among others, to environmental taxes, energy efficiency and acceleration of permits for renewable energy installations.

Financial sector policies

The resilience of the financial sector has improved in recent years, but in light of the risks ahead, retaining sufficient capital for potential downside risk scenarios is crucial, in particular for less-significant institutions. The Italian banking sector has weathered the pandemic well, thanks to improved resilience in recent years, and supported by government measures such as public guaranteed loan schemes and loan moratoria. However, financial stability risks are rising in a context of a challenging macroeconomic and political environment. With a few exceptions, the capital buffers of banks have increased, but the risks ahead underscore the need to maintain prudent dividend policies and credit risk management to retain sufficient capital buffers for potential downside risk scenarios. While liquidity buffers have remained reassuring, tightening financial conditions are likely to put pressure on the funding costs of banks, in particular in the segment of banks with lesser presence in wholesale markets, also increasing financing costs for the real economy. We agree with Staff that while interest rate increases could improve banks' profitability, it may also impact negatively asset quality in some less-significant institutions, and should be carefully monitored. In the latter, governance has been significantly improved in recent years, but Authorities should keep promoting turnaround processes of weaker banks, including through consolidation. Finally, we also agree with the Staff's view that the performance and quality of NPLs, which have largely exited the banks' balance sheets but remain within the financial system, require continuous monitoring.

**Statement by Mr. Andrianarivelo, Mr. Sylla, and Mr. Nguema-Affane on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for the set of interesting papers and Mr. Fanizza for his helpful Buff statement. We broadly share the thrust of the staff appraisal and would like to make the following comments for emphasis.

Italy's strong recovery from the pandemic is welcome but the geopolitical tensions and the ongoing internal political situation as well as the monetary policy tightening are dampening Italy's growth outlook for 2022. Appropriate Covid-related policy measures have contributed to control the pandemic and support a strong rebound in economic activity. Russia invasion in Ukraine and the subsequent sanctions are clearly affecting economic activity and have clouded prospects through higher energy prices and heightened energy security concerns due to Italy's high reliance on Russia's gas exports. The shutoff scenario clearly highlights the need to press ahead with diversification of energy sources, including through the REPowerEU plan, to strengthen energy security and preserve growth. The authorities have rightly taken compensation measures to ease the impact of the energy price shock on the most vulnerable. While these measures and the implementation of the National Recovery and Resilience Plan (NRRP) are expected to support near-term growth, an intensification of the war in Ukraine, tighter financing conditions and persistent high inflation will present Italy with significant risks to the economy. Moreover, the ongoing political turmoil in the current environment is a source of concern, as it could exacerbate risks to the outlook and further undermine confidence. *Staff's update and assessment of the current political crisis in Italy will be appreciated.*

Pursuing growth-friendly fiscal consolidation will be critical to keep the high public debt on a downward path. With the improved epidemiological situation, the withdrawal of most pandemic-related support has helped improve fiscal balance and public debt ratios. Since the inception of the war in Ukraine, priority is rightly accorded to mitigate the impact of higher energy prices on the most vulnerable, although targeting should be improved. We are pleased to note that excess energy-related fiscal revenue will be used in this regard, which should not affect the achievement of the medium-term fiscal adjustment objectives. However, the limited fiscal space amid high debt and rising borrowing costs stresses the need to step up fiscal consolidation efforts. While favorable automatic debt dynamics are expected to bring down public debt, we agree that maintaining fiscal prudence will be of the essence should fiscal risks materialize, including the realization of pandemic-related credit guarantees. In that context, the authorities should consider staff proposal to undertake a comprehensive review of existing tax and spending programs to identify potential measures to help improve fiscal and debt sustainability. *We note the authorities' emphasis on combating tax evasion and would appreciate staff further comments on this issue*

Financial stability should be preserved in the current challenging context. We note the resilience and improved health of financial system during the pandemic and the limited banks' exposure to Russia and Ukraine. Despite most of the pandemic-related support expiring, the financial system is a strong position to withstand the inflation and interest rate shocks while supporting economic growth amid heightened uncertainty around the macroeconomic outlook. The extension of the publicly guaranteed liquidity schemes for energy-intensive sectors is in our view appropriate in the near-term. We agree with staff that postponing dividend distribution and share buyback and limiting provision drawdown might be needed to preserve capital given the high uncertainty. We encourage further progress in the implementation of the 2020 FSAP recommendations, in particular regarding AML/CFT supervision of financial institutions.

Advancing structural reforms, notably under the NRRP, will be essential to increase productivity, support green transition and enhance transparency. We welcome the authorities' continued commitment to a full and timely implementation of the NRRP to advance the transformation of the economy and increase growth potential. The modernization of the public administration will go a great way towards improving the business environment and supporting public and private investment. We commend the authorities for the progress made in decarbonizing the economy but recognize the setback on that front caused by disruption of gas supplies. This stresses the need to accelerate green investment to make further strides towards the country's climate goals, but the authorities should ensure that incentives in that regard are cost-effective. Finally, we encourage the authorities to make further progress in strengthening the anti-corruption and AML/CFT frameworks.

With these remarks, we wish the Italian authorities and population success in their endeavors.

**Statement by Mr. Moreno and Ms. Moral Betere on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for their insightful report and the timely selection of issues in the context of the Italian Article IV consultation. We also thank Mr. Fanizza for his informative Buff statement, and we associate ourselves with Mr. Posso's statement. We broadly concur with the thrust of staff's appraisal and would like to make the following comments.

The spillovers from Russia's war against Ukraine cast uncertainty after a strong and successful recovery from the pandemic. We commend the Italian authorities for their timely response to the pandemic, which has allowed a stronger recovery than expected. The measures taken to protect the most vulnerable from higher energy prices have also been appropriate. However, risks to the outlook are high due to the uncertainty surrounding the conflict and its consequences and the normalization of monetary conditions. Going forward, the NGUE funds and investments will be key to boosting long-term growth and persevering with structural reforms to address longer-term challenges while transitioning to a greener, more digital, and sustainable economy.

We commend the authorities for the improvement in the public finance position, even after new spending measures associated with higher energy prices. The strong recovery and the withdrawal of the pandemic measures have allowed an improvement in debt and deficit figures, despite the additional temporary spending measures taken to mitigate the impact of higher energy prices. So far, these measures have been appropriate, and we concur with staff that they should become more targeted and temporary. We also welcome the measures taken to reduce Italy's dependence on Russian gas by diversifying supply sources and simplifying procedures for investments in renewable energy as stated in the Buff. Going forward, we concur with staff that fiscal policy should remain prudent with a certain degree of flexibility given the high uncertainty.

In the medium term, growth-friendly fiscal consolidation as well as structural reforms will be key to ensure debt sustainability. In the medium term, fiscal policy should continue focusing on reducing the debt-to-GDP ratio, both through a gradual consolidation strategy and by increasing potential growth through investments and reforms. Regarding the latter, a timely and effective implementation of the Recovery and Resilience Plan remains of the essence. On the consolidation front, we share staff's view that the broadening of the tax base and strengthening tax compliance should be complemented with current spending growth control and increased efficiency. We welcome the authorities' conservative approach to

budgetary projections and positively note that, despite increasing financing costs, the improved debt maturity profile will help to maintain the debt burden on a downward trajectory in the coming years, but close monitoring of financing costs will be of essence. *In this vein, could staff comment on the potential effects of the recently approved Transmission Protection Instrument by the ECB?* Finally, fiscal sustainability should also be reinforced through the monitoring of the financial situation and performance of state-owned enterprises (SOEs).

The continued improvement in the strength of Italian banks is very encouraging, but given the elevated uncertainty, banks should remain vigilant and prepared to deal with extreme scenarios. Italian banks' capital and liquidity positions have strengthened, and households and firms maintain large liquidity cushions, helping them weather higher prices and interest rates, while direct and indirect exposures to Russia and Ukraine seem moderate and manageable. However, the end of the guarantee schemes, alongside the tightening of financial conditions and slower projected growth, advises very close monitoring of weaker sectors and companies. We support staff's recommendation that banks prepare for severe downside events using appropriate and regular stress-testing of credit and other exposures. Dealing with weaker banks, and improving digitalization and governance in the sector, as well as close monitoring of the GACS-covered loans, also remains a priority.

A timely and full implementation of the reforms and investments envisaged in the Recovery and Resilience Plan (RRP) will be crucial to boost Italy's medium-term growth and underpin the green and digital transitions. We commend the authorities for their comprehensive and well-designed Recovery and Resilience Plan (RRP), which shows its commitment to closing the public investment gap and helping to raise Italy's productivity and growth potential. We particularly welcome that some reforms have been front-loaded and are already delivering, such as the reforms to modernize the public administration, the judiciary, and the tax administration, as well as the simplification of civil procedures and the spending reviews, which will be key to improving the business environment and attracting private investment. We also welcome Italy's progress towards decarbonizing its economy to meet its climate goals and its commitment to climate change adaptation and mitigation, evidenced by the fact that 70 billion euros have been earmarked for investments in the green transition. We concur with staff that carbon price reform may be useful but that, under the current circumstances of high energy prices, its scope and timing should be carefully calibrated.

With all these remarks, we wish Italy and its people all the best in their future endeavors.

Statement by Mr. Zhang and Mr. Huang on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the insightful set of reports and Mr. Fanizza for his helpful Buff statement. After being hit hard by the pandemic crisis, the Italian economy rebounded more strongly and quickly than the post GFC and euro debt crisis. However, the recovery is facing new setbacks because of geopolitical tensions. The authorities also need to build political consensus to carry out much-needed reforms to address the long-standing vulnerabilities of high public debt and low labor productivity. We agree with the thrust of staff's appraisal and would like to limit ourselves to the following comments for emphasis.

Energy Sector

A series of policy measures have been taken to help enterprises and households to cope with surging fuel prices. We take positive note that these measures are time-bound, as they are rolled over on a quarterly basis. But more than half of them have universal coverage and/or is distorting the price signal. We encourage the authorities to replace the untargeted measures with targeted ones in the future quarterly roll-over. These measures are rightly funded in part by windfall revenues from energy companies. More targeting will also help to reduce the fiscal cost.

With around 40 percent of gas imported from Russia, Italy has been heavily burned by the sanctions on Russia's energy sector. As the authorities rushed to find alternative energy supplies, it is understandable some of the gaps would be filled by delaying the retirement of coal power plants. It is more urgent than ever to scale up investments in renewable energy such as solar and wind. Besides streamlining approval procedures, removing non-tariff trade barriers on basic materials could also lower the cost of such renewable energy transition.

Fiscal Policy

Despite a positive averaged primary surplus during the past two decades, public debt-to-GDP has steadily risen, indicating weak growth is the key piece of the puzzle. As the pandemic further increased the ratio, a growth-friendly fiscal consolidation is key for Italy to grow out of debt. Recent tightening financial conditions raised government's borrowing costs. We agree with staff that there might be a brief window of time when cost of debt remains below nominal growth. The authorities expected such favorable automatic debt dynamics will continue at least for the next two years. *Could staff comment on the length of the opportunity window, especially when considering the ECB's recent rates hike?* Together with the move on the rates, the ECB also introduced a new policy instrument of Transmission Protection Instrument (TPI). *Could staff provide some initial thoughts on the impact of the TPI on Italian government's borrowing cost and public debt dynamic, as the central banks have already held around 30 percent of its sovereign bonds?*

Turning to more specific fiscal adjustment measures, it is essential to broaden the tax base and improve tax compliance on the revenue side.

We see merits in staff's policy suggestions of updating the real estate taxable value, given its

progressive nature. On the expenditure side, keeping the non-interest current spending growth rate of 1-2 percentage points below normal GDP is appropriate to create more space for pro-growth capital spending. Although being politically difficult, actions are needed to reform the overly generous pension system, in the context of unfavorable demographic trends.

Financial Sector

We take positive note that the banking sector's financial situation has improved, with equity and liquidity position strengthened and non-performing loans at historical low. However, continuous monitoring of the financial sector is warranted given the elevated uncertainty and tightening financial conditions. Banks' holdings of sovereign bonds did not substantially increase but stay high. The strong sovereign-bank nexus could lead to a self-reinforcing adverse feedback loop, should the worst scenario materialize. We join staff in suggesting banks to perform scenario-based assessments and decide whether temporary conservation of capital is needed.

The progress made on strengthening supervision of less-significant institutions is welcome. More should be done to address small banks that are weak. The public guarantee schemes (PGSs) managed to help corporates maintain credit access during the pandemic. *Could staff elaborate on how the PGSs was incorporated into the government contingent liability and public debt sustainability analysis?* We agree with staff that any new PGSs should be selective and with banks retaining sizable residual credit risk.

Structural Reforms

Staff rightly pointed out that low growth potential is a reflection of weak investment, eroding labor productivity and a shrinking workforce. Italy's labor productivity has been stagnating in the past decade. The rigid labor market and centralized wage bargaining system helped to moderate wage growth and wage-price spiral risk, but also hampered labor reallocation and productivity growth. We encourage the authorities to speed up much-needed labor market reforms to achieve a stronger growth. With more than 500 milestones and targets, the National Recovery and Resilience Plan (NRRP) provides a unique opportunity to reverse underperformance on prior reforms and public investment programs. We welcome the authorities' commitment to a steadfast implementation of the NRRP, as indicated in Mr. Fanizza's Buff statement.

Climate Change

We note with concern that the authorities' climate target would only be half done if maintaining the current rate of progress. We have some different views with the authorities on carbon taxation, as the Buff statement stated that "to be effective, carbon taxation should be implemented only in the context of an EU coordinated approach that includes a Carbon Border Adjustment Mechanism (CBAM)." We caution against using the CBAM as a prerequisite for carbon taxation. Those countries at early stage of economic growth should have more time and space to achieve a green transition, and countries at a more advanced stage have the responsibility to take the lead.

With these remarks, we wish the authorities every success in their policy endeavors.

Statement by Mr. Mizuguchi, Ms. Kashima, and Ms. Ogihara on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the informative report and Mr. Fanizza for the insightful buff statement. We welcome that the Italian economy rebounded from the pandemic in 2021 and output recovered to its pre-COVID level by early 2022. However, the economy is facing unprecedented challenges and uncertainty, including the historic inflationary pressures exacerbated by the Russian invasion of Ukraine, supply disruptions, and global tightening, which could further compress growth and risk fiscal sustainability. We also note the recent political developments, and *would like to ask staff's views on their implications to the approval of the 2023 budget and implementing necessary measures for the EU post-pandemic fund.* Addressing subdued productivity growth and climate change is also vital to put the economy on a strong growth track. We broadly agree with staff's policy recommendations and offer a few comments for emphasis.

Energy Security

Energy shocks put significant challenges and risks to the Italian economy, and we note with concern that households and firms are facing a severe increase in energy costs. Mitigating price shocks is vital, and we welcome the authorities' swift relief measures to support vulnerable groups and energy-intensive firms. Energy security concerns have largely increased, and the government's efforts to secure alternative energy supplies and promote changes in energy sources are becoming even more important. As staff notes, shifting to more targeted measures with price signals is also needed to enhance energy efficiency and conservation.

Fiscal Policy

We welcome that the fiscal deficit and debt ratios have declined in 2022, despite the implementation of additional support measures to mitigate the impact of higher energy prices and the progress in NRRP projects. We also appreciate the authorities' efforts to support refugees from Ukraine. We agree with staff that faster fiscal adjustments could be considered given high inflationary pressures and risks surrounding the economy, and comprehensive fiscal reforms are vital to deliver a primary surplus of 2 percent of GDP no later than 2030. Broadening of the tax base and a comprehensive review of the budget are needed, as highlighted in Box 2, while prioritizing spending to support long-term growth and social inclusion.

Financial and Corporate Sector Risks

Most Italian financial institutions weathered the pandemic well, supported by public guarantee schemes (PGSs) to maintain credit flows. However, due to the elevated uncertainty, funding costs for sovereign and banks could further increase. The performance of guaranteed loans should be closely monitored, given that the authorities' stress test implies the need for sufficient fiscal resources to cover materialization of contingent liabilities. Careful monitoring of credit risks in the non-financial sector is also needed. Also, it is important to avoid NPLs from remaining on banks' balance sheets for a prolonged period. In

this regard, improving debt restructuring toolkits and in-court procedures are steps in the right direction. Regarding bank capital, we agree with staff that dividend payout and share buy-back strategies could be reconsidered, in light of the limited capacity of banks to withstand severe downside events. Supervision and monitoring of vulnerabilities of less-significant institutions' (LSIs) should be continued, and bank mergers facilitated in order to achieve economies of scale to enhance digitalization and cybersecurity.

Structural and Climate Policies

It is necessary to accelerate efforts to enhance human capital and infrastructure in order to address Italy's low and uneven productivity. Multi-faceted NRRP reforms will encourage private activities and boost potential growth, and thus its full and timely implementation is important. We also emphasize the need to strengthen the anti-corruption and AML/CFT frameworks, and to implement the register of beneficial ownership information. Regarding climate issues, we welcome the authorities' efforts toward emission reduction, but further measures should be considered to achieve the "Fit for 55" target. As it has become more difficult to secure affordable and sustainable energy while pursuing decarbonization, it is necessary to enhance carbon taxes and green investment incentives in an effective manner, while being mindful not to harm Italy's competitiveness.

**Statement by Mr. Bevilaqua, Mr. Saraiva, and Mr. Fisher Hogan on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for their comprehensive reports and Mr. Fanizza for his useful statement. Italy recovered from the pandemic without meaningful economic or financial scarring, yet now it faces significant challenges, including those related to the war in Ukraine, which could dent recent progress.

Growth in 2022 is expected to moderate considerably and understandably with respect to last year, due to the war in Ukraine and monetary policy tightening, on top of base effects. However, baseline prospects continue favorable, and we are reminded by Mr. Fanizza's statement that Italy is the single outlier among G7 economies with recent upward revisions in growth projections. Over the next five years, however, growth is expected to remain stable at around $\frac{3}{4}$ of a percent. Moreover, headline inflation increased four-fold over the last year, with the bulk of such dramatic move due to surging energy prices. This presents important challenges, as low growth rates and high energy vulnerability trim short and medium-term forecasts and increase risks. Spikes in prices or a rapid repricing in yields could materially change the outlook on external conditions or domestic issues in a short notice.

A sound fiscal strategy that ensures consolidation and sustainability over time is key to manage risks to public finances and the real sector. We praise the authorities' commitment in phasing out pandemic-era support, and their moves to replace such policies with new, more focused initiatives to cope with the current shock. We appreciate the fact that increased subsidies were budget-neutral, tapping from higher energy sector incomes. This will support the authorities' efforts to increase revenue performance and control expenditures. That said, we agree with staff that measures should focus on temporary and targeted fiscal compensation for households to weather the current energy crisis. Timely withdrawal of compensation measures as energy prices sustainably moderate is of the essence.

We would encourage the authorities to save non-energy cyclical and structural additional revenues to help Italy cope with a heavy debt burden, releasing fiscal space for needed investment. Even under pessimistic assumptions, borrowing costs will decrease as high-interest securities retire, the ECB rolls over holdings and new issues replace these assets. Yet, the authorities should preclude from excessively relying on the favorable effects of automatic debt dynamics to reduce debt burden over time, as such auspicious dynamics may fade in the next few years.

As the authorities put forward the National Recovery and Resilience Plan (NRRP) to expand the frontiers of Italy's growth potential, they signal a credible push towards sizable and sustainable improvement in the primary balance. While the authorities

proceed to meet NRRP targets, their aim remains a higher than planned surplus and a heightened emphasis on growth. *On that note, we ask staff for their views about the process of building consensus around the fiscal path and the structural reform agenda supported by NRRP policies under the current political transition.*

The financial sector exhibits signs of improvement since the onset of the pandemic, although Euro Area monetary tightening could present meaningful fresh challenges.

The authorities complied with key FSAP recommendations, including credit-risk analysis for less significant banks, loan classification, NPL provisioning practices and strengthening the macro prudential framework. Direct exposure to Russian assets remains low. At the same time, we take note that a higher interest environment may favorably impact bank profitability, as stated by Mr. Fanizza. That said, high debt burdens and sizable rollover requirements add adverse feedback channels that could damage the outlook for sovereign credit, non-financial corporates and banking institutions.

Italy's external position is broadly in line with the level implied by medium-term fundamentals, and the key external sector vulnerability relates to energy dynamics.

If estimated losses in GDP reach the forecasts suggested by staff in a more severe scenario, Italy could face a steep economic contraction. To preempt this looming possibility, the authorities are diversifying oil and gas supplies and eased restrictions to enact greenfield investment in renewables. Priorities should be apportioned according to the non-linear impact such energy scarcity will inflict on sectoral value chains. On that note, energy and other intermediate inputs are key to manufacturing firms, which have experienced persistent difficulties in procuring supplies. That said, we take note of the authorities' policies in sharing windfall gains to lower prices for end-users.

Finally, we take note of the authorities' efforts in decarbonization and in AML/CFT efforts. More targeted electricity taxes dissuade polluting and fossil-fuel alternatives to greener and clean sources, but even an advanced economy such as Italy needs assistance for these schemes to be effective. Such policies, particularly carbon pricing, require EU support, as noted by Mr. Fanizza's statement. Also, a thorough assessment of the Superbonus 110 tax credit scheme may be warranted, as its limited applicability hints at regressivity and other design challenges. Furthermore, we commend the authorities' steps to strengthen the effectiveness of their AML/CFT framework, and the establishment last June of the Register of Beneficial Owners.

With these remarks we wish the Italian authorities all success in their endeavors.

**Joint Statement by Mr. Huh, Ms. Lim, Mr. Dacharux, and Mr. Yoo on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for the informative report and Mr. Fanizza for the helpful buff statement. We broadly agree with the thrust of staff's appraisal and offer additional comments as follows.

Italy saw strong economic recovery in 2021, although the economic outlook is significantly dimmed by the impact of the war in Ukraine as well as tightening financial conditions. With high inflation, consumption is expected to be constrained by eroding purchasing power. We note the high level of energy poverty and correspondingly disproportionate burden of the high energy prices on lower income households. While we welcome the compensation packages to mitigate the adverse impact of the energy price shock, broad-based measures could lead to inefficient leakages and risk fueling overconsumption. We thus share staff's advice on restoring price signals and improving targeting of the measures, to efficiently protect the most vulnerable population and facilitate necessary energy adjustment. Given Italy's high dependence on imported energy, we welcome the plan to diversify energy sources to enhance economic resilience as well as the detailed analysis of the impact of a gas shortfall scenario on the economy in Annex X.

Continued efforts to keep the elevated public debt on a firm downward path remain important. Despite output returning to pre-pandemic level, government bond yields have increased and spreads over German bunds have widened on the back of high public debt and the ECB's policy normalization. We appreciate the elaboration on fiscal targets in Box 2-3 and support the two-pronged strategy as proposed by staff to credibly reduce fiscal deficit and debt ratios over the medium term. To this end, we welcome the authorities' plan to a declining deficit path, including with the view that bringing primary surplus to 2 percent of GDP is appropriate and achievable. *With the Risk Assessment Matrix in Annex I listing the lack of policy continuity with high impact, what is staff view regarding Italy's risk perceptions given the recent collapse of the ruling coalition?* While we appreciate the section on Policies for a Severe Scenario, analysis on the extent to which the very sharp growth downgrade staff envisioned would constrain authorities' ability to provide the recommended pandemic-era policy tools and relevant fiscal adjustment would have been useful to help understand the policy tradeoffs.

We note staff's assessment of the improved health of the Italian banking sector throughout the pandemic, and the limited direct exposure to Russia. Notwithstanding the low flow of new NPL formation, the increase in NPLs in early 2022 as the economic outlook weakens and interest rates rise warrants continued monitoring. If Guarantee on Securitization of Non-Performing Loans (GACS) Scheme is to be extended to ease pressure on NPLs, measures to limit government's risk exposure should be accompanied. We welcome the progress made on the 2020 FSAP recommendation implementations as detailed in Annex V.

Structural reforms continue to be critical to lift potential growth and support the green transition. Declining labor productivity and the disparity across subnational regions should be addressed to boost competitiveness and reduce polarization. Comprehensive active labor market policies, including upgrading skills and retraining, and strengthening social safety nets will be

essential. It is important to foster investor confidence by the authorities demonstrating continued commitment on the National Recovery and Resilience Plan (NRRP) and other EU-related facilities. We positively note the authorities' achievement in decarbonizing the economy in the past decade and encourage them to expedite work toward the ambitious "Fit for 55" targets, including through energy carbon taxes based on carbon content and support for green investments. *Could staff comment on how the delayed phaseout of coal power plants would impact Italy's climate goals?*

**Statement by Mr. Binzarah and Mr. Saeed on Italy
Executive Board Meeting 22/71
July 27, 2022**

We thank staff for the insightful papers and Mr. Fanizza for the helpful Buff statement. We welcome the strong economic recovery from the pandemic supported by balanced and effective policy response. Nonetheless, downside risks to the outlook remain significant, which highlights the need to maintain agile and prudent policies to secure the recovery and enhance economic resilience over the medium-term. **We broadly agree with the thrust of staff appraisal and would like to add the following remarks.**

Sound fiscal policy aided strong recovery and reduced fiscal deficit and debt ratios. Nonetheless, we underscore the importance of maintaining steady reduction in public debt over the medium-term. We also concur with staff that fiscal reforms are vital to place the public debt on a firm downward path while creating room for critical investment spending. We particularly highlight the importance of reforms to improve tax compliance and broaden the tax base as well as reforms to enhance spending efficiency and restrain recurrent spending growth. Fiscal support measures to cushion the impact of high energy prices should be temporary and well-targeted. To that end, we welcome the recent improvement in the primary balance despite additional temporary spending, which is a step in the right direction.

Financial sector health and stability have improved yet cautious approach to bank capital is warranted given the possibility of protracted economic downturn. We positively note the decline in NPLs and the improvement in banks' profitability. That said, the need of additional loan-loss provisions required to mitigate the potential increase in NPLs going forward should be closely monitored. We welcome progress made on the implementation of the 2020 FSAP recommendations and support a proactive supervision approach to enhance capitalization of small- and medium-sized banks. We concur that banks' dividends distribution policy should be carefully reviewed and adapted to the changing environment.

Timely and effective implementation of the National Recovery and Resilience Plan (NRRP) is instrumental for crowding in private investment and fostering Italy's growth. We positively note that milestones for 2021 and the first half of 2022 were achieved, and we encourage the authorities to continue with the timely implementation of NRRP reforms. Further, the implementation of the NRRP should be supported by advancing efforts to reinforce economic governance and strengthen the AML/CFT framework. On climate

policies, we tend to agree with the authorities that relying on further carbon taxation to accelerate the energy transition at this juncture is not practical given the already high energy taxes in Italy and the absence of EU coordinated approach. Here, we caution against the overreliance on carbon taxation and pricing in view of rising threats to energy security, which if materialized could have significant implications for Italy's macroeconomic stability and growth and inflation prospects. We, therefore, reiterate our position that the Fund should tailor policy advice on climate based on country circumstances and the regional context, which is critical to enhance the traction of the Fund policy advice and its role as trusted advisor on climate issues.

With these remarks, we wish the Italian authorities and people well in their endeavors.

Statement by Mr. Hilbers and Mr. Milutinovic on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the excellent report and Mr. Fanizza for his insightful Buff statement. We broadly share staff's appraisal and associate ourselves with Mr. Poso's statement. We would like to offer the following comments for emphasis.

As Italy has successfully recovered from the pandemic, spillovers from Russia's war in Ukraine are clouding its economic outlook. The effective pandemic-related measures have secured an impressive rebound of the economy. However, rising inflation fueled by the energy price shock, energy security issues, and monetary tightening amid high debt levels all weigh on the economic outlook. We also note the Italian economy is vulnerable to the Russian gas shutoff, which would result in a significant output decline. In this regard, staff's report strikes the right balance between discussions on the war spillovers, structural policies, and fiscal sustainability.

We commend the authorities' fiscal response to the fallout from the war while keeping the deficit contained. We were encouraged to find that policy support to alleviate the energy price shock significantly compensated the most vulnerable households while adhering to the original 2022 deficit target. Yet, we concur with staff that additional measures should be targeted, temporary, and compatible with deficit reduction. Furthermore, as the Russian gas shutoff is the key risk to the economy, securing energy supplies in coordination with the EU partners is the immediate policy priority. *Has staff discussed contingency plans in case of a Russian gas curtailment?*

A growth-friendly fiscal consolidation strategy, alongside comprehensive reforms, is essential to ensure fiscal sustainability. The tightening of financial conditions increased fiscal risks as public debt has reached 150% of GDP in the previous year. Therefore, we welcome the authorities' commitment to raising the primary surplus to 2% of GDP to ensure a strong declining debt path, as staff suggested. The analysis shows that lifting potential growth is the key to Italy's fiscal consolidation, and required fiscal efforts are very sensitive to medium-term growth. In this regard, insights into the 2nd round effects of budgetary measures—through disaggregated fiscal multipliers for each revenue and expenditure category—would help design a growth-friendly consolidation package. *Staff comments are welcomed.*

While the financial sector's resilience has improved, emerging risks require vigilance. We were encouraged that the banking sector's financial health has improved, thanks to government measures and the implementation of the 2020 FSAP recommendations. The energy crisis' escalation may require additional liquidity support to affected businesses, especially for vulnerable SMEs. In this context, we concur with staff that publicly guaranteed loans are the most suitable and that banks should be required to retain a larger part of the credit risks for new guarantees.

We applaud the authorities for their swift implementation of the RRP, which is crucial in boosting Italy's potential growth and accelerating the green transition. As Italy has successfully delivered on the current RRP milestones, keeping the momentum of its well-designed reform agenda is essential to uplift potential growth. We also agree with staff that the complementarity of reforms,

such as increasing public sector and judiciary efficiency, simplifying regulation, promoting digitalization, and boosting capital stock, is necessary to tackle lagging productivity. Furthermore, while we recognize previous decarbonizing efforts, meeting the climate targets will require accelerating the green transition, mainly by unlocking investment into renewables.

Statement by Mr. Bhalla and Mr. Natarajan on Italy
Executive Board Meeting 22/71
July 27, 2022

1. We thank the staff for the detailed report and Mr. Fanizza for the informative Buff. Italy's economy which rebounded strongly after contraction due to the pandemic is facing challenges due to global supply disruptions, high energy prices and rise in inflation. Rising energy prices have significantly affected the households and businesses. Focusing on effective implementation of investments under the National Recovery and Resilience Plan (NRRP) and targeted support for vulnerable households is fiscally prudent and sustainable. Enhancing labor productivity, supporting green energy transition, and strengthening governance framework will help to boost long-term growth prospects.
2. The economy which contracted severely by about 9 percent in 2020 rebounded strongly with a growth of 6.6 percent in 2021. Going forward, economic activity is expected to slow down due to a sharp rise in energy prices, supply chain disruptions and rising interest rates. Inflation has increased sharply from less than 2 percent in 2021 to over 8 percent in June 2022. Energy bills have increased significantly impacting household consumption and businesses. Current account surplus is expected to decline in the near-term due to surge in energy import prices. We welcome the authorities' focus on fiscal prudence and sustained growth by prioritizing investments and targeted support measures for vulnerable households and firms.
3. Fiscal situation has been gradually improving from a deficit of over 6 percent in 2020 to 3.6 percent in 2021. Increased spending on compensation packages to help households and firms from energy price increases is proposed to be partly financed from windfall revenue from energy. Given the high deficit and debt levels, we concur on the need for timely and efficient implementation of NRRP investments. *As windfall tax is key for supporting the additional revenue, could the staff provide an assessment of the potential revenue, mechanism of taxation and the sectors which are covered under the windfall tax?*
4. The financial sector is strong and stable with adequate capital and liquidity position, and a reduction in NPLs in banks. However, given the downside scenario due to multiple uncertainties, the risks are required to be monitored closely. We concur on strengthening the supervision of small banks with low asset quality and addressing weaker banks facing difficulties in business and profitability. In the context of rising energy prices and input costs affecting businesses, we welcome the measures for strengthening debt restructuring and streamlining legal processes for business restructuring.
5. We take note of the concern of the authorities regarding the impact of unilateral changes in carbon taxes as it would pose risk to the country's competitiveness in the absence of a coordinated EU approach. We encourage strong measures to boost human capital to address the declining labor productivity. We welcome the new regulations and institutional processes to enhance AML/CFT effectiveness for cooperation on financial intelligence.

6. Finally, we wish the authorities the best in their efforts.

Statement by Mr. Stephan and Mr. Krahnke on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for an informative report and Mr. Fanizza for his helpful Buff statement. **We broadly agree with staff’s assessment.** The Italian economy has rebounded strongly from the pandemic-induced shock, also thanks to the appropriate policy response. The outlook for the Italian economy remains uncertain at the current juncture considering high (albeit gradually declining) dependency on energy imports from Russia, a prospective tightening of financial conditions, concerns about the high public debt ratio as well as weak productivity growth. Renewed political uncertainty clouds the outlook. It is important that the Italian reform agenda now stays on track. We associate ourselves with the Gray by Mr. Pösö and would like to add the following points, mainly for emphasis:

We note with concern the staff projections regarding longer-term debt developments and agree with staff that public debt “needs a further sustained and significant reduction” to safeguard debt sustainability. Market confidence has to be secured by adequate domestic policies. We encourage the authorities to conduct a timely, ambitious, and sustained consolidation ensuring a reliable reduction in the public debt ratio. However, the envisaged primary surplus of two percent of GDP to be reached in 2030 is not overly ambitious. A more ambitious path seems to be advisable and achievable. Historically, Italy achieved higher primary surpluses for consecutive years. A significantly lower public debt ratio is also crucial for domestic stability in Italy as well as to avoid creating adverse spillovers for the euro area and the global economy. Possible further support measures in response to currently elevated downside risks materializing should be temporary, targeted and deficit neutral. Additional windfall tax gains would best be used to further reduce the fiscal deficit. We encourage staff to point out that debt statistics are insofar incomplete as they do not record national shares in EU debt used for transfers.

Continuous structural reform implementation and investments according to Italy’s national plan (NRRP) will be important to secure further tranches from the EU’s Next Generation EU (NGEU) facility to support the green and digital transition and to lift the country’s trend growth. Project design and planning of investments should be mindful of potentially limited absorption capacity in parts of the southern regions and islands, in which a large part of the investments is foreseen.

On structural policies, we encourage the authorities to implement an ambitious reform agenda to strengthen growth and raise labor productivity. To avoid additional burdening of public finances from the pension system, we agree with staff that indexation of the retirement age to life expectancy could be a helpful step while better linking benefits to lifetime contributions. The expiration of the early retirement scheme at end-2022 would be a welcome step towards more viability of the pension system in the context of an already high

old-age dependency ratio and adverse demographic developments. We also encourage the authorities to re-evaluate the indexing of old-age pensions to headline CPI inflation in this context.

We take positive note of the authorities' advancements in decarbonizing the economy and encourage them to take additional steps to reach their national climate goals.

Unifying carbon taxes across sectors and adjusting energy taxes to better reflect carbon content, as proposed by staff, seems to be a worthwhile exercise to minimize the costs of the transition.

Statement by Mr. O'Brolchain and Mr. Mooney on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the comprehensive report and Mr Fanizza for his useful Buff statement. Despite a rigorous rebound and recovery from the COVID-19 pandemic, formidable challenges, uncertainty, and weak trend-growth have resulted in an outlook tilted to the downside. Italy is especially vulnerable to energy price pressures, and a potential suspension of Russian supplies would significantly reduce output in the short term. While Italy's National Resilience and Recovery Plan (NRRP) and other expected reforms should support demand and alleviate some of these risks, its timeline for implementation remains uncertain. **We agree with the thrust of the report and offer the following points for emphasis.**

The authorities' fiscal stance throughout the pandemic was appropriate but has resulted in an increase to an already high public debt. Support aimed at addressing the increase in energy prices should remain temporary and well targeted at vulnerable households and industries. In order to improve fiscal sustainability, the authorities should look at widening the tax base, reducing tax expenditures, lowering taxes on labor, and modernizing the property tax system. We positively note the recent strengthening of tax compliance measures, including the introduction of electronic invoicing and reporting.

We welcome the increased resilience of the financial system in recent years, which should enable the sector to withstand aggregate shocks around the baseline scenario. Increased capital and liquidity buffers in the banking sector are welcome and should be underpinned by prudent dividend policies and credit risk management. We commend the authorities for the progress made on the key recommendations from the 2020 FSAP, as outlined in Annex V, particularly in the operation of less-significant institutions (LSIs). We welcome the ongoing strengthening of the AML/CFT framework and the associated work with the OECD and G20, as outlined in Annex VI.

We welcome Italy's comprehensive NRRP, which should be fully implemented in a timely manner to support necessary productivity improvements and boost potential growth. We note the analysis around labor productivity in the Selected Issues Paper (SIP) and strongly agree with staff that the NRRP should provide a comprehensive impetus to essential reforms. We welcome the analysis around the green transition in the SIP and agree with staff that meeting the climate goals will require important enhancements to the existing policy framework, as well as restructuring carbon taxation. We encourage the authorities to swiftly implement the reform in the NRRP pertaining to the improvement of measures to encourage female entrepreneurship, particularly in light of the decrease in female employment since 2019.

Joint Statement by Ms. Mannathoko, Mr. Mohieldin, Mr. Abdullahi, and Mr. Al-Kohlany on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the informative set of reports and Mr. Fanizza for his helpful Buff statement.

We commend the Italian authorities on the robust performance of the economy and its remarkable resilience in the wake of an effective policy response to a pandemic induced slump. The ongoing commitment to full implementation of the National Recovery and Resilience Plan (NRRP) is welcome as it will help sustain this performance in the face of new shocks. The NRRP rightly addresses long standing structural challenges such as low productivity and high debt levels. After the severe 9 percent economic contraction in 2020 due to the pandemic, the Italian economy recovered in 2021 growing at 6.6 percent, however, this momentum risks being dampened by the war in Ukraine, continued supply chain disruptions, and tightening of financial markets, thus both short- and medium-term measures to sustain recovery are important. We broadly concur with the staff analysis and recommendations and offer the following comments.

We agree with the urgency of measures needed to address spillovers from the war in Ukraine, even as the authorities continue to implement the NRRP in the wake of the pandemic. Limiting the economic impact of this shock is a priority, in order to safeguard growth momentum, despite the surge in inflation. This requires both short-term measures and short to medium term planning for a possible gas supply shock. We take positive note of the steps taken to diversify Italy's energy sources and to simplify investments procedures in renewable energies as indicated in Mr. Fanizza's Buff statement.

The narrowing of the fiscal deficit reflecting strict controls on fiscal spending alongside large windfall revenue gains, is noteworthy. We welcome the authorities' commitment to maintain the 2022 budget deficit target of 5.6 percent. Considering the limited fiscal space and high debt levels, we agree with staff that it is important to ensure that the measures aimed at mitigating the spillovers from the war in Ukraine particularly, the high energy prices, should be temporary and targeted. In the same vein, the compensation for high energy price to provide relief to households and firms should nevertheless preserve the price signal and declining fiscal path.

We welcome the authorities' commitment to lowering the deficit ratio and debt level. Public debt, which rose 20 percentage points to 155 percent in 2020 before starting to moderate again in 2021, continues to face pressure as public sector financing requirements remain substantial, highlighting the importance of an effective medium term fiscal strategy.

Strong revenue performance and strict expenditure control should help sustain improvement in the primary balance. Continued prudence is especially important under a baseline scenario of low growth and high primary deficits, an aging population and associated pension spending, and rising interest rates. All these factors will continue to put upward pressure on public debt. Accordingly, we support the two-pronged medium-term strategy of fiscal adjustment to reduce the high deficits and debt level. To achieve this strategy, robust domestic revenue mobilization and comprehensive structural reforms will be required, to boost productivity and stimulate growth.

While the banking sector's health has improved in recent years, propped up by supportive programs, it faces elevated risks and uncertainties going forward. We, therefore, urge the authorities to carefully monitor the sector including smaller and weaker banks, as current supportive programs are wound down. We join staff in encouraging banks and the authorities to pay close attention to potential adverse feedback channels between the sovereign, corporates and banks, in the rising interest rate environment amidst weak growth and high public debt. We appreciate the indication in the Buff that a cautious approach to bank capital is needed, including consideration of restrictions on dividend distributions on a case-by-case basis, depending on each bank's capacity to withstand a severe, lengthy economic downturn. We note the progress made on 2020 FSAP recommendations and encourage the authorities to prioritize the implementation of the remaining FSAP recommendations.

The progress made on the climate agenda is noted and we commend the authorities for the sharp fall of CO2 emissions since 2000 and for keeping their emission intensity below the EU average. Like staff we also note that more needs to be done to achieve the "Fit for 55" target and encourage the authorities to accelerate climate mitigation and adaptation, and efforts to limit energy security risk. We welcome the measures taken to improve efficiency and cost effectiveness of green investments. As noted by the authorities, in addition, reduction of carbon emissions through a carbon tax will require a coordinated EU approach, with due consideration given to distributional impacts. *We would appreciate staff comments on their expectations for such coordinated action by the EU.*

We appreciate staffs' discussion of policies for a severe downside scenario and see some merit in their proposal for a scaled down pandemic-era type response, reflecting limited fiscal space, inflation pressures and tightening financial conditions alongside high public debt. At the same time, we believe country specifics and a data driven response should inform the size and type of response in such a scenario, with a view to safeguarding macroeconomic and social stability at the same time. We note that the authorities consider pandemic-era measures as appropriate in the case of such a severe downside scenario.

As declining labor productivity, and regional productivity disparities caused by large gaps in physical and social infrastructure need to be addressed, accelerating the NRRP

is important. Thus, we support the authorities' commitment to timely implementation of the frontloaded ambitious reforms and investments under the NRRP. Like staff we encourage strengthening the anti-corruption and AML/CFT frameworks to help safeguard gains from reforms and investments under the NRRP. *Could staff elaborate on the challenges faced by the authorities and corrective strategies in place to effectively implement these complex reforms and public investment programs.*

We would appreciate staff comments on the implications of the sudden resignation of Prime Minister Mario Draghi for the reform agenda.

Statement by Mr. Palotai, Mr. Just, and Mr. Samuda on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for the informative and well-written documents and Mr. Fanizza for his insightful Buff statement. Italy navigated well through the COVID-19 pandemic and has rebounded strongly. We commend the outstandingly successful vaccination campaign in Italy. The decisive policy response helped staying afloat of a larger macroeconomic downturn and deeper scarring of the economy. Nevertheless, the risks are now skewed downwards given the global economic developments, but also due to the political uncertainty in Italy at this juncture. With Russia's war against Ukraine fueling existing vulnerabilities, the authorities will have to once again navigate through stormy economic waters. We would like to associate ourselves with the statement by Mr. Pösö and offer the following comments for emphasis.

We broadly agree with staff's assessment. Nevertheless, with the global monetary stance, and the economic and political situation rapidly evolving, the outlook is uncertain. While this is of course not unique to the Italian economy, the most immediate risk for Italy's outlook remains a complete and prolonged shutoff of the Russian gas supply in a context of a domestic political uncertainties, constraining the ability to quickly and effectively react to negative economic shocks.

Italy's fiscal space will continue to remain limited due to high public debt levels and the necessity to cushion the effect of another economic shock. The current economic situation and negative spillovers from the war against Ukraine will demand careful and well-designed fiscal responses. **Support to vulnerable households and industries need to remain targeted, temporary and kept at arm's length from political interference around elections.**

It is in Italy's very own interest to address and manage the public debt situation in the medium term to create fiscal leeway to respond to future shocks. This will have to be implemented gradually and with due consideration of the evolving economic situation. A growth-friendly consolidation, underpinned by structural fiscal reforms, is also warranted to ensure better fiscal-monetary coordination.

In light of the current economic headwinds, we strongly encourage the authorities to take on board staff's policy advice on longer-term fiscal consolidation efforts, investments in green energy, greener industries, the digital transition and energy security. This should be flanked by a more growth-friendly tax system, a broader tax base and reduced taxes on labor in the medium term. We are encouraged by the Buff statement that the authorities follow the objective of bringing the debt-to-GDP ratio to its pre-pandemic level by 2030, which would reduce the debt service burden and complement the recommended primary surplus of 2 percent of GDP at the latest by that time.

The Recovery and Resilience Facility (RRF) and other EU Funds have set in motion a series of reforms which could foster longer-term resilience to shocks and result in a long-term improvement of economic prospects. We commend the authorities for the steps

already taken but note that not many of the reforms have advanced significantly in the political process and that on politically sensitive reforms such as in fiscal, land registry or competition thus far only minimal changes have been proposed. In addition, implementation of the NGEU reforms will require steadfast commitment also by future governments. The authorities should also be careful not to impinge upon areas of already successfully implemented reforms ahead of the elections amid a challenging economic outlook. We further call on the authorities to reinforce and continuously modernize Italy's governance framework.

We acknowledge that progress has been made in recent years in advancing the financial sector's resilience against larger shocks and capital buffers of banks have overall increased. We agree with Mr. Fanizza's Buff statement, that higher interest rates could possibly be beneficial to the banking sector and banks' profitability has improved recently. However, continued monetary tightening and the risk of a likely rising share of non-performing loans (NPL) cloud the outlook. Against this backdrop, we agree with staff's call for continued monitoring of NPLs. We call for prudent credit risk management, sound supervision practices and monitoring of liquidity buffers.

We welcome the strong emphasis of the Italian NRRP in green investments and the green transition. This will have to include a reduction of environmentally harmful subsidies. Reducing Italy's reliance on fossil fuels, especially Russian gas, will also provide for positive longer-term growth and improve energy independence. We understand from the selected issues paper's section on green transition, that Italy could promptly adopt some measures with limited risks to its competitiveness. *We would be interested in concrete policies that could be recommended in the absence of an EU-coordinated approach on carbon taxation, especially in the context of Italy's already very high energy taxation.*

Statement by Mr. Peter and Mr. Kuth on Italy
Executive Board Meeting 22/71
July 27, 2022

Italy's economy recovered strongly from the pandemic shock, and we welcome that employment has also rebounded. However, renewed domestic political uncertainty and deteriorating geopolitical and economic conditions are compounding long-standing domestic vulnerabilities, providing new headwinds for Italy. Against this background, it is paramount to (i) continue fiscal discipline given high public debt, (ii) maintain a cautious approach to bank capital, and (iii) accelerate key structural reforms.

Fiscal discipline remains important to maintain debt sustainability. Given Italy's elevated public debt and with growth projected to slow, we agree that fiscal prudence is warranted. In line with staff, we stress the need to adopt and stick to a credible strategy to put debt on a gradual downward path. To this end, a medium-term fiscal framework could be considered. To achieve a steady improvement in the primary balance, the authorities should broaden the tax base, strengthen tax compliance, and restrain growth in current spending. Compensation measures should protect the most vulnerable from higher food and energy prices. However, it is important that these measures are targeted and temporary and that their scale reflects the more constrained fiscal space. Furthermore, preserving price signals and avoiding distortions are key. Looking further ahead, policy considerations for containing fiscal pressures stemming from the pension system appear warranted.

Given the elevated uncertainty, a cautious approach to bank capital is warranted to preserve financial stability. We welcome the progress made on numerous FSAP recommendations and note that the banking sector's financial health has improved since the start of the pandemic. However, slower growth prospects, rising interest rates, and high debt levels are likely to put pressure on bank capital, which could give rise to adverse feedback channels between the sovereign, corporates, and banks. Therefore, banks should closely monitor the quality of their assets to detect the build-up of credit risks and prepare for potential severe downside events. We also commend the authorities for amending their Insolvency Code, which, according to staff, may provide a potentially straightforward out-of-court mechanism for debt restructuring.

Continued progress with the implementation of key structural reforms is critical to boosting productivity and potential growth and accelerating the transition to net-zero emissions. Given the shortcomings in the implementation of reforms in the past, we call on the authorities to quickly break the deeply concerning political impasse and commit to full and timely implementation of the reforms and investments under the National Recovery and Resilience Plan (NRRP). To achieve a sustained lift in trend growth and, hence, strengthen the economy's debt-carrying capacity, structural reforms are indispensable to improve the

business environment, promote efficient investments in infrastructure, improve education and labor market outcomes, reduce the potential scarring from a possible energy crisis, and provide the necessary support for the green transition. *Staff comments on the implications of not implementing the reform and investment plans under the NRRP would be welcome.*

Policy changes are needed to accelerate the decarbonization and digitalization of the economy. Plans to delay the phase-out of coal-fired power plants as part of the response to the worsening energy crisis make efforts to support the green transition more urgent. For example, better targeting environmental taxation and further simplifying procedures for renewable energy infrastructure projects could increase energy supply and reduce carbon emissions, while providing additional stimulus to growth. We also call on the authorities to continue their efforts in digitalizing the Italian economy.

Statement by Mr. Mozhin and Mr. Potapov on Italy
Executive Board Meeting 22/71
July 27, 2022

1. **We thank staff for the insightful reports on Italy and Mr. Fanizza for his informative Buff statement.** The Italian economy has been facing significant and longstanding macroeconomic imbalances and structural impediments that hold down growth and exacerbate fiscal and financial difficulties. The recent political turmoil, as well as geopolitical developments and related sanctions weigh in on the outlook. Financial conditions have sharply tightened against the background of political uncertainty and monetary policy normalization in Europe and the U.S. Financial vulnerabilities remain high, given the substantial banks' exposure to sovereign bonds. High public debt and rising borrowing costs highlight the need for a sustained fiscal adjustment and ambitious structural reforms.
2. **Despite a strong post-pandemic recovery, the economic difficulties that the country has been experiencing are visible across various metrics.** Over the recent years, the economic and financial situation in Italy has been repeatedly featured as one of the key risks to the euro area and even to the global economy. Living standards have yet to recover to their pre-GFC level, while GDP per capita remains close to its level almost two decades ago. Productivity has been stagnant and there have been persistently high rates of youth unemployment. The Fund's Article IV and flagship reports consistently referred to fiscal policy uncertainty, elevated sovereign spreads, and weak investment in the country. The pandemic crisis exacerbated these challenges, although a stronger than expected recovery was an important positive development.
3. **The growth outlook remains challenging and is subject to uncertainty and downside risks.** Rising energy prices are expected to compress households' real spending and squeeze firms' profit margins. Real GDP growth is projected to average around 1 percent over the medium term. *Could staff elaborate on an impact of the severe drought across the Northern part of the country on growth and inflation? Could staff also comment on how the new episode of political uncertainty can impact the NRRP implementation and the related financing disbursements?* In the report staff provided an extensive analysis of a hypothetical scenario of full interruption of gas supply from Russia. *To complement this analysis, could staff elaborate on how the authorities' decision to restrict imports of Russia's coal and oil and their plans to ban Russia's gas since 2024 influence growth, inflation, and energy prices?*

4. **Broadening price pressures have pushed both headline and core inflation.** More inflationary pressures might be expected in the near term, as can be gauged by the tightness of the labor market and elevated producer prices. Staff believe that nominal wage growth can remain modest due to the forward-looking nature of the collective wage bargaining framework and the strong cyclical in foreign worker flows. *In case a wage-price spiral materializes, could staff elaborate on possible contingency measures the authorities should implement to contain inflation and mitigate risks to export competitiveness?*

5. **The most pressing problem relates to the sustainability of Italy's public debt.** The overall fiscal deficit in 2020-2021 was on average around 8.5 percent of GDP, and it is expected to remain relatively high at 5.6 percent of GDP this year. Not surprisingly, public debt-to-GDP ratio has jumped from about 135 percent to around 150 percent. We understand that higher nominal GDP growth and spending ceilings set on below actual inflation can help improve the primary fiscal balance in the near term. We also welcome staff's recommendations for the fiscal adjustment measures to be implemented from 2023. *At the same time, we missed staff's clear assessment in the DSA whether Italy's public debt is sustainable under the current set of policies over different time horizons, in view of subdued growth prospects, rising borrowing costs, elevated sovereign spreads, and population aging. Staff's comments would be appreciated. Could staff also elaborate on the prospects of using a new Transmission Protection Instrument in the ECB toolkit for purchases of Italy's sovereign bonds?*

6. **While the soundness of the banking sector has been improved, rising financial stability risks warrant a cautious approach to banks' capital.** As highlighted by staff, rising interest rates amid weaker growth and high public debt could give rise to adverse feedback channels between the sovereign, corporates, and banks. Further progress is needed to implement the key recommendations from the 2020 FSAP.

7. **Structural reforms are needed to boost growth potential and address poor productivity performance.** We welcome the authorities' efforts to implement the NRRP that is rightly concentrated on supporting infrastructure, improving education, promoting digitalization, and addressing income distribution. Addressing governance vulnerabilities can help increase the efficiency of the key reforms and priority spending. Further efforts are needed to reduce carbon emissions.

Statement by Ms. Medearis and Mr. Westphal on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for this report and Mr. Fanizza for the informative Buff statement. We note that Italy's GDP has fully recovered since the pandemic, and we agree with staff that longstanding issues of high debt, weak productivity, and low potential growth are again sources of potential concern. Heightening these vulnerabilities, the war in Ukraine has triggered a surge in energy prices, and anticipated monetary policy tightening has contributed to rising government bond yields. **We urge the authorities to continue following through on implementing structural reforms designed to raise potential growth, in addition to pursuing medium-term fiscal consolidation.** *We would appreciate an update from staff and their views on recent political developments since staff distributed this report and the potential impact on financial conditions given the resulting widening of spreads.*

We agree that in light of Italy's high debt and rising financing costs, the authorities should steadily and decisively improve the primary balance going forward. We underscore the continued risks of Italy's high debt stock coupled with the weak growth outlook, especially in the face of current external headwinds. We agree with the recommendations to modify the tax system and to pass on current higher energy costs to end users. Relatedly, we echo the recommendation to target energy support measures to vulnerable firms and households rather than implement across-the-board cuts in taxes and fees. We concur with staff's recommendation to prioritize future reforms to the pension and early retirement programs. We also agree that the authorities should update real estate values to increase taxable equity.

We welcome efforts by the authorities to carry out comprehensive structural reforms to improve potential growth. We agree with staff that stronger growth will be crucial to putting debt on a downward trajectory. We applaud that the authorities have met all the 2021 and 1H2022 targets under the National Recovery and Resilience Plan (NRRP), aimed at boosting long-term sustainable growth and improving productivity. We encourage the authorities to follow through on their climate and decarbonization goals, even as they attempt to balance energy security and affordability in the wake of Russia's invasion of Ukraine. We also appreciate staff's analysis in Annex X of the potential impact of a full shutoff of Russian gas, and we urge the authorities to continue to work toward their decarbonization goals to increase energy security over the medium term. The NRRP's financing for green investments will also be key to helping Italy meet climate commitments amid uncertainty.

We applaud the authorities' progress on implementing recommendations to improve bank supervision from Italy's 2020 FSAP, and we agree that banks should prepare for downside scenarios in light of heightened uncertainty and downside risks. Banks should utilize scenario-specific assessments to monitor exposures to NPLs and any potential adverse feedback loops. We also agree that any new loan scheme should be selective and that banks are better placed than the government to take on the potential credit risk of banks' clients. We welcome the implementation of Italy's new Insolvency Code to streamline out-of-court

private sector debt restructuring mechanisms, which should help to increase available capital by encouraging efficient court procedures. We applaud the authorities' ongoing efforts to strengthen the AML/CFT framework, particularly regarding cooperation and the exchange of information and financial intelligence. We also agree with staff recommendations to increase the availability of information related to beneficial ownership.

Statement by Mr. Hosseini and Mr. Sassanpour on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for a set of high-quality papers and commend them for the comprehensive coverage of authorities' views on virtually every issue. We also found the analytical SIPs quite relevant and very informative. We further express our appreciation to Mr. Fanizza for his insightful Buff statement. We are in broad agreement with the thrust of the staff appraisal.

The Italian economy rebounded sharply from a deep slump caused by the pandemic thanks to the authorities' timely and proportional policy response, a successful vaccination campaign, and a quick recovery of external demand. The near-term outlook, however, has become murkier in the past few months reflecting the fallouts from the war in Ukraine (particularly regarding energy), severe drought conditions in parts of the country and, more recently, the political impasse that has already been reflected in a widening of yield spreads. *Would staff indicate to what extent domestic political risks have been incorporated in staff analysis?* The current fluid political situation also risks delivering NRRP investments and reforms that provide the framework and multi-year funding for tackling Italy's structural and greening issues. There are other downside risks, some of which have already become more apparent. The Staff Report discusses policies in the event of an adverse scenario but stops short of its quantification.

Going forward, the policy priorities are to address Italy's energy security issues (both in the near term as well as over a longer horizon) in view of its high dependence on imported gas; to ensure that public debt (in relation to GDP), already very high, is placed on a steady downward path; to deal with old-age issues and demographic changes; and to lift Italy's potential growth by addressing its the deep-seated productivity issues and labor market shortcomings.

On the fiscal front, we welcome the positive outturn in the first half of the current year and agree with staff that additional revenue from higher growth and inflation and gains from tax compliance should be saved. We commend the authorities for the protection of vulnerable groups during the pandemic and, as recommended by staff, encourage them to use the tax on windfall profits of energy companies to alleviate the higher cost of energy on households and firms in a targeted and budget-neutral manner. The duration and extent of support, in our view, should be condition-based. *There are reports that a supplementary stimulus package (of euro 13 billion) is under preparation. Has it been discussed with staff? And if so, is it budget-neutral?* We welcome the authorities' commitment to a paced fiscal consolidation plan to achieve (and maintain thereafter) a primary surplus of 2 percent of GDP before 2030 to ensure that the debt ration stays on a firm downward track and to create room for priority investments. Staff's recommendations merit serious consideration.

On the financial sector, its resilience and moderate direct exposure to Russia are comforting. Stock of legacy NPLs is low, there has been no material increase in formation of new NPLs due to the crises, and banks are well provisioned. The quality of the large stock of NPLs outside banks, however, needs close monitoring. We support staff's recommendations for banks to conserve capital by reviewing the timing of dividend payouts and postponing the drawdown of loan loss provisions, on bank-specific cases, following a scenario-based assessment of banks' loan quality and exposures. We positively note the progress that has been made on numerous recommendations of the 2020 FSAP and encourage the authorities to implement the remaining recommendations in a timely manner.

On structural reforms, we agree with staff's emphasis on the complementarity of reforms needed to boost Italy's lagging productivity. We also note the wide divergences in sectoral and regional productivity, mostly attributed to disparities in the quality of human capital. We expect the Italian authorities to take full advantage of the NRRP's multi-faceted and front-loaded reforms to modernize public administration and the judiciary, and more generally build infrastructure and institutions that would support growth.

On carbon pricing, we agree with the authorities that in view of the already-high energy prices and in the absence of a coordinated EU approach, unilateral changes in carbon tax would pose unnecessary risks to Italy's competitiveness.

We wish the Italian authorities every success.

Statement by Mr. Buissé, Mr. Roman, and Mr. Grossmann-Wirth on Italy
Executive Board Meeting 22/71
July 27, 2022

We thank staff for a very good set of reports, including the very useful Selected Issue papers. We also thank Mr. Fanizza for his clear and informative Buff statement. We agree with the thrust of staff's appraisal, and we associate ourselves with Mr. Pösö's statement. We would like to offer the following remarks for emphasis and questions to staff:

We agree with staff and the authorities that the Italian economy has rebounded strongly from the pandemic. It is now however facing a significantly worsened outlook.

The authorities' comprehensive policy response has helped the economy weather the diverse shocks particularly well since the start of the pandemic, and we agree that the resilience of the Italian economy has been remarkable. The rebound in economic activity has been stronger than expected and GDP returned to its pre-crisis level in early 2022. The consequences of the Russian war against Ukraine, including the accompanying rise in energy prices, are however severely weakening growth prospects, also amongst higher uncertainty related to the risk of further gas supply disruptions and the tightening of financial conditions. The political situation following the resignation of Prime Minister Mario Draghi on July 21 adds to the uncertainty. *On the labor market, could staff further elaborate on the outlook for the labor force participation rate in light of the NRRP implementation and associated reforms?*

We commend the Italian authorities for the improvement in public finances and support the continuation of structural reforms to ensure further decline in public debt.

The current projections now translate into primary surpluses by 2025 and a sharp reduction in the public debt ratio (to 142% in 2025 according to staff, compared to 155% in 2020). We agree with staff that a careful articulation between targeted support to vulnerable households and fiscal consolidation is warranted. The implementation of structural reforms will also be essential to support growth and help decreasing further the public debt, while preserving long-term investments. In this regard, we agree with staff on the importance of pursuing the implementation of the reforms foreseen in the NRRP. This is even more the case given the productivity challenges discussed in the first SIP paper. Italy has met the targets and milestones for the first tranche of funds under the NRRP and has submitted its application for the second tranche of funds for the second half of 2022. Major investments are still expected, with a peak in 2023-2024. We also welcome the reform of the public procurement code and note that the role of local authorities will be key in the successful achievement of the upcoming targets.

We agree with staff on the recommendation to increase green investment and to improve carbon taxation. We congratulate staff for a very insightful SIP on climate. While

Italy has made good progress in reducing GHG emissions and improving energy efficiency, more progress is needed to meet climate goals. We agree on the need to increase green public and private investment and on the need to improve carbon taxation to better differentiate between renewable and fossil energy sources and to accelerate the price increase of CO2 emission rights. We note and support the Italian authorities call for a coordinated approach, which should not be an obstacle to advance swiftly. We also agree that the approval process for renewable energy projects could be simplified, as in other countries. The installment of renewable generation capacity (as well as the simplification of procedures) is part of the NRRP. As the "car ecobonus" seems to work well, we consider that the aid would benefit from being reinforced and extended (funds allocated are insufficient to renew the car fleet).

We consider that the financial sector resilience has improved. However, sufficient capital buffer should be constituted for potential downside risk scenarios, in particular for LSIs. In line with Mr. Pösö's statement, we consider that the Italian banking sector has weathered the pandemic well, thanks to improved resilience in recent years, and supported by government measures such as public guaranteed loan schemes and loan moratoria. However, there is a need to maintain prudent dividend policies and credit risk management to retain sufficient capital buffers for potential downside risk scenarios. We agree with Staff that while interest rate increases could improve banks' profitability, it may also impact negatively asset quality in some less-significant institutions, and should be carefully monitored. Again in line with Mr. Pösö's statement, we also agree with the Staff's view that the performance and quality of NPLs, which have largely exited the banks' balance sheets but remain within the financial system, require continuous monitoring.

**Statement by Rasmus Rueffer (ECB Representative) and Sander Tordoir (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.

Italy

Responses to Technical Questions Posed by Executive Directors in Advance of
EBM/22/71—July 27, 2022

Staff's responses to technical questions are below. Broader policy questions in the areas of appropriate policy mix to keep public debt on a firm downward path will be addressed in staff's intervention at the Board meeting.

Outlook and Risks

1. Could staff elaborate on an impact of the severe drought across the Northern part of the country on growth and inflation?

- With around 60 percent less rainfall than the historical average and temperature about 2° Celsius hotter than in recent years, several agricultural groups (the Farmers' Association – Coldiretti, the Italian Farmers Confederation—CIA-Agricoltori Italiani, and the General Confederation of Italian Agriculture—Confagricoltura) estimate that around 6–10 percent of the value of national agricultural production (equivalent to 0.1–0.2 percent of total GDP) will be lost this year. In some areas, the losses to fruit and vegetable crops could be as high as 70 percent, while the estimated losses of wheat range from 20 to 40 percent. This could put further pressures on crop/fresh produce inflation, which has been on the rise since early this year.
- In addition, the drought has severely reduced hydro power generation (20 percent of total generation capacity), thereby compounding scarcity in gas supplies.

2. In case a wage-price spiral materializes, could staff elaborate on possible contingency measures the authorities should implement to contain inflation and mitigate risks to export competitiveness?

- The series of measures adopted by the authorities in response to energy price increases to compensate households for the erosion of real incomes and provide tax credits to energy-intensive firms to ease the cost shock and insulate external competitiveness should help to prevent triggering a wage-price spiral. In addition, with the benchmark for wage indexation being Istat's annual three-year forecast of consumer prices excluding imported energy products, this should also help to contain wage inflation. If, however, a price-wage spiral were to materialize, monetary policy is the appropriate tool for containing second-round inflationary effects and anchoring inflation expectations.

3. In particular, we would expect a somewhat more positive evolution of the labor market, with unemployment declining further from current levels, supporting somewhat higher consumption.

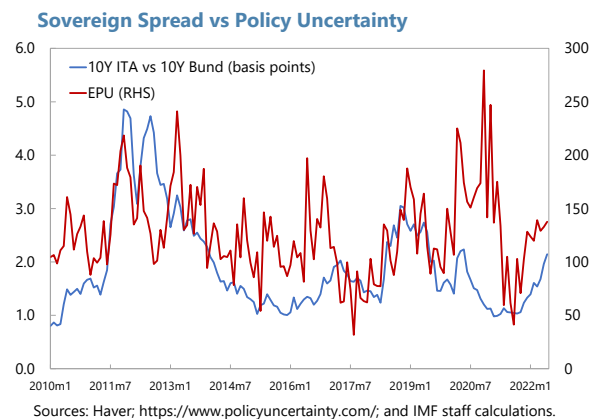
- Italy's unemployment rate has fallen sharply to an historical low of just over 8 percent in mid-2022. However, as noted in footnote 3, since the COVID crisis, direct labor market transitions from employment to inactivity—and vice versa—have increased significantly in Italy, bypassing unemployment. Moreover, Italy's very open labor market implies that unemployment rates are not very sensitive to economic cycles, as labor is sourced from

abroad during upturns, and released abroad during downturns (Box 1). This is also consistent with the rigidities in the domestic labor market, where skill and geographical mismatches between jobs and Italian workers are significant.

- Staff's forecasts for employment indicate a sustained increase over the projection period (with the exception of 2023 when growth is projected to slow sharply), pointing to a favorable evolution of the labor market.
 - Upskilling and retraining Italian workers is a priority to reduce labor market mismatches and to ensure much improved employment prospects, including through reduced reliance on temporary employment contracts.
4. **[Moreover, the ongoing political turmoil in the current environment is a source of concern, as it could exacerbate risks to the outlook and further undermine confidence.] Staff's update and assessment of the current political crisis in Italy will be appreciated.**
 5. **We also note the recent political developments, and would like to ask staff's views on their implications to the approval of the 2023 budget and implementing necessary measures for the EU post-pandemic fund.**
 6. **[While the authorities proceed to meet NRRP targets, their aim remains a higher than planned surplus and a heightened emphasis on growth.] On that note, we ask staff for their views about the process of building consensus around the fiscal path and the structural reform agenda supported by NRRP policies under the current political transition.**
 7. **With the Risk Assessment Matrix in Annex I listing the lack of policy continuity with high impact, what is staff view regarding Italy's risk perceptions given the recent collapse of the ruling coalition?**
 8. **Could staff also comment on how the new episode of political uncertainty can impact the NRRP implementation and the related financing disbursements?**
 9. **We would appreciate an update from staff and their views on recent political developments since staff distributed this report and the potential impact on financial conditions given the resulting widening of spreads.**
 10. **Would staff indicate to what extent domestic political risks have been incorporated in staff analysis?**
 - Prime Minister Draghi resigned after several parties in the national unity government failed to vote in support the current government's agenda. Parliamentary elections are scheduled for September 25, and a new government could be installed by late- November. PM Draghi and his cabinet will serve in a caretaker capacity in the interim, but will have only limited policy - making powers. As a result, delays are likely in approving the 2023 budget law and in delivering some of the reforms and investments envisaged in the NRRP.

- EU member states are expected to send their draft budgetary plans (DBP) to the European Commission (EC) by mid-October (in line with the European Semester framework). In preparation, the autumn update to Italy's Economic and Financial Document (DEF) is usually approved by Parliament in late September/early October. This update informs the DBP with updated macroeconomic forecasts, as well as an outline of the main fiscal targets for the next few years. The main policy changes envisioned by the government are also usually described in the Update to the DEF. If the 2023 budget is not approved by end-December, there would be an extension of the 2022 budget until April 2023. Between January and April, the government would be allowed to spend 1/12 of the budget each month.
- Regarding reforms and investments in the NRRP, some 55 milestones and targets are expected to be met during H2:2022. Several of these will require decisive governmental steps and Parliamentary approval of reforms. As such, delays can be expected at least until a new government is in place. This would delay the release of the associated €21 billion in EU financial support.

- Such delays come at a time when Italy is facing numerous global and regional economic challenges, which could heighten policy uncertainty and reduce the ability to provide effective macroeconomic support. Longer-term effects are also feasible unless the momentum for reform and debt reduction is firmly maintained. The market's perception of increased risk is reflected in higher sovereign yields and spreads.



- Domestic political uncertainty is considered a downside risk in the report. In paragraph 11, this is reflected in the risk of a rapid tightening of financial conditions, including from “domestic considerations,” and concerns about difficulties delivering NRRP investments and reforms. In addition, Annex 1 refers to “lack of policy continuity,” including the risk of snap elections. This latter risk has now materialized; however, it remains to be seen whether or not the structural reform agenda and other policies remain on track.

Energy Security and Gas Shut-off

11. In the report staff provided an extensive analysis of a hypothetical scenario of full interruption of gas supply from Russia. To complement this analysis, could staff elaborate on how the authorities' decision to restrict imports of Russia's coal and oil and their plans to ban Russia's gas since 2024 influence growth, inflation, and energy prices?

- In Italy, coal constitutes a small share of primary energy consumption (around 3 percent), while oil accounts for a much larger 42 percent. Coal and oil are globally-traded commodities, and to a large extent, their prices reflect the balance of global demand and supply conditions. World prices of both fossil fuels have risen over the past year—oil prices are up by around 40 percent, but have dropped in recent weeks on slower world demand, while coal prices have risen by more than 150 percent. These price increases are considerably smaller than the increase in TTF gas prices over the same period (by around

780 percent). In the near term, higher oil and coal prices put downward pressure on households' purchasing power and firms' profit margins, negatively affecting output. At the same time, much higher fossil fuel prices—and with gas futures prices remaining high for several years—encourages energy conservation and investments in clean energy, thereby helping Italy accelerate its green transition, and which could generate a positive growth dividend over the medium- and long-term.

12. Has staff discussed contingency plans in case of a Russian gas curtailment?

- The Italian authorities have made a significant progress in securing alternative supplies of energy that would allow for offsetting about the half of normal Russian gas imports in case of a full shut-off, including by: (a) continuous storage buildup despite gas supply disruptions; (b) greater recourse to other suppliers, such as Algeria, Azerbaijan, Qatar, Congo, Angola and Mozambique, including via increasing imports of liquefied natural gas; (c) delaying the retirement of coal power plants, thereby freeing up gas for other uses; (d) increasing domestic gas production; and (e) regulatory measures, such as thermostat regulation in public buildings. Demand for gas will be also reduced due to further increases in gas prices. The remaining gas supply shortfall could be met by larger seasonal drawdown of gas inventories and, if needed, quantity rationing through the activation of the emergency level as defined by [the Italian natural gas system's Emergency Plan](#).
- Italy's gas system emergency plan has three stages: (1) early warning level (the current status since February 2022); (2) alert level; and (3) emergency level. If a "state of alert" is activated, this would trigger a series of measures aimed at reducing the consumption of gas, including decreasing gas demand from interruptible commercial contracts, ramping up production at the country's coal power plants and also seeking additional gas imports from other suppliers. An "emergency" level would allow, among other measures, for limiting gas use for power generation, the compulsory reduction of gas withdrawal by industrial customers, definition of new temperature and/or schedule thresholds for the domestic heating sector supplied with natural gas.

Fiscal

13. As windfall tax is key for supporting the additional revenue, could the staff provide an assessment of the potential revenue, mechanism of taxation and the sectors which are covered under the windfall tax?

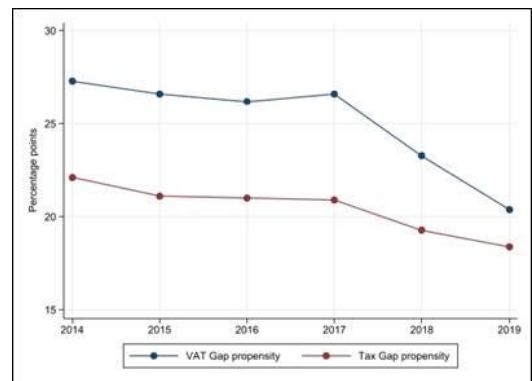
- Italy introduced a windfall tax on energy firms to capture economic rents that were created for some firms being able to sell energy at considerably higher prices than their input costs owing to (i) resale of gas on the wholesale market at prices much higher than the cost of gas imports determined in long-term import contracts, and (ii) selling prices of renewable electricity are considerably higher than in previous years given links to gas prices even though the cost of renewables generation has not risen. Because retail prices are linked to wholesale spot markets, many end-users ended up paying higher prices than consistent with the size of Italy's terms of trade shock.
- Collecting part of windfall profits through a surtax on energy firms has helped to finance compensation to end users without expanding the fiscal deficit. The government expects to collect around €11 billion (2/3 percent of GDP) in revenue from the surtax on energy

companies' profits. A 25 percent tax rate is applied to the increase in profits, where profit is proxied by the net of active and passive VAT accounts, during October 2021–March 2022 compared with the same period the previous year.

- The definition of the tax base has elicited some criticism from the industry given that it could overestimate actual profits, which include not only VAT-able items, but also financial transactions, such as hedging and asset purchases and sales. The current definition was selected because it could be readily and promptly computed, which helped provide a spending envelope for energy relief measures.

14. We note the authorities' emphasis on combating tax evasion and would appreciate staff further comments on this issue.

- The authorities' emphasis on further strengthening tax compliance is appropriate as the revenue foregone from tax evasion is significant. The Italian authorities for example estimate the tax gap propensity (the difference between taxes owed based on the potential tax liability and what is actually collected) at about 18 percent of the potential tax liability (or, equivalently, 5 percent of GDP).
- As noted in the Supplemental Information Annex, Italy has benefited from Fund (as well as OECD) advice especially in fiscal areas, including technical assistance on tax administration and tax policy reform. Traction has been especially strong in the area of tax administration, where recent reforms have addressed past IMF recommendations, including on the organization of the revenue agency at the regional level, strengthening the management of compliance risks and VAT compliance management, and improving the revenue performance of key taxpayer segments. More recently, the revenue administration introduced electronic invoicing and has been actively engaged in the introduction of big-data methods to strengthen its risk-based approach to tax compliance. This continuous effort is progressively paying off. Since 2017, the tax gap propensity has declined by about 4 percentage points of the potential tax liability, including almost 7 percentage points on VAT. The reduction has been especially sizeable since the introduction of electronic invoicing.



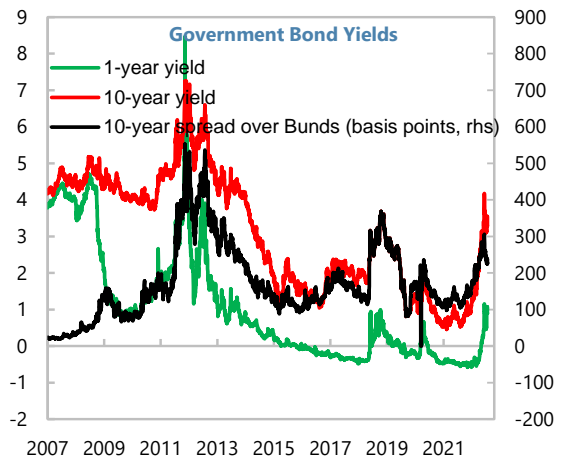
Source: Ministry of Finance, Italy.

15. There are reports that a supplementary stimulus package (of euro 13 billion) is under preparation. Has it been discussed with staff? And if so, is it budget-neutral?

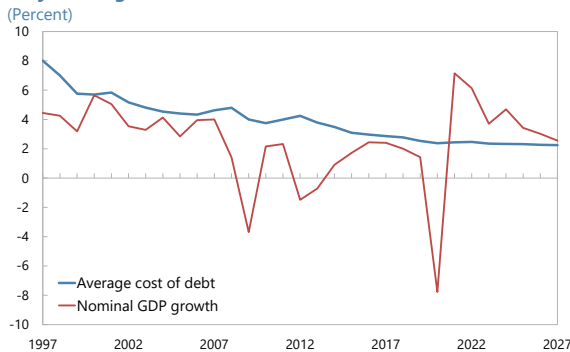
- According to information in the press, the government is considering a new package of measures to compensate households for high prices. While the new package is currently under preparation by the Cabinet, early reports suggest that the upcoming fiscal intervention could amount to €12–13 billion (¾ percent of GDP) and include VAT cuts on selected basic food items, and a further extension of the excise tax cut on diesel and gasoline fuels until end-September. The measure may also extend the €200 bonus for lower-income households. According to press reports, Minister Franco has confirmed this new fiscal intervention would be financed from the proceeds of stronger-than-projected revenue performance in the first half of the year, suggesting that, as has been the case with other interventions during the energy crisis, this new package would be budget-neutral.

16. [The authorities expected such favorable automatic debt dynamics will continue at least for the next two years.] Could staff comment on the length of the opportunity window, especially when considering the ECB’s recent rates hike?

- The recent increase in government borrowing costs at issuance implies that the future decline in the effective cost of debt will now be shallower and shorter-lived than previously anticipated. As illustrated in the chart below, borrowing costs at issuance are projected to increase significantly already in 2022 (partly due to inflation-linked bonds) and continue to rise over the forecast horizon. As a result, the continuous declining trend in the effective cost of debt over the last several years is projected slow considerably, and then to reverse by around 2026. However, automatic debt dynamics are still projected to remain favorable for the next 4–5 years, with nominal GDP growth above the effective nominal cost of debt, mainly due to a temporary acceleration in the GDP deflator. This should help bring Italy’s public debt ratio down close to its pre-pandemic level by the end of the forecast horizon.

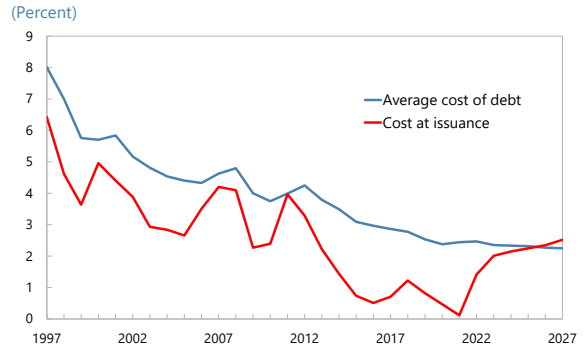


Italy: Average Cost of Debt and Nominal GDP Growth



Sources: Haver; and IMF staff estimates.

Italy: Cost of Debt



Sources: Haver; and IMF staff estimates.

17. [The analysis shows that lifting potential growth is the key to Italy's fiscal consolidation, and required fiscal efforts are very sensitive to medium-term growth. In this regard, insights into the 2nd round effects of budgetary measures—through disaggregated fiscal multipliers for each revenue and expenditure category—would help design a growth-friendly consolidation package.] Staff comments are welcomed.

- Lifting potential growth and achieving a stronger fiscal balance are needed to keep public debt on a firmly declining path over the longer term. To support this strategy, and in addition to structural reforms to boost growth, staff calls for a comprehensive review of the budget to find meaningful savings from existing spending and tax programs (including tax expenditures). This budget review should identify and streamline spending that is of low quality and inefficient—and hence has a modest fiscal multiplier, while creating room for priority spending on public infrastructure investment and education, which carries a large fiscal multiplier. Areas for savings include: increasing the efficiency and targeting of social benefits, closely linking lifetime benefits to lifetime contributions in early retirement pension schemes, making tax incentives and climate subsidies cost effective, reducing a wide array of tax expenditures and strengthening tax compliance.

18. [The public guarantee schemes (PGSs) managed to help corporates maintain credit access during the pandemic.] Could staff elaborate on how the PGSs was incorporated into the government contingent liability and public debt sustainability analysis?

- As part of the emergency response to the COVID crisis, public guarantees on bank loans amounted to 10 percent of GDP at end-2021. The government has so far set aside some €20 billion (1 percent of GDP) in reserves to cover risks from pandemic-related guarantees, implying a maximum expected loss rate of around 12 percent.
- Regarding staff's debt sustainability analysis, the potential impact of PGS on public finances is incorporated through the materialization of a contingent liability shock, consisting of a one-time increase in non-interest expenditure that is standardized to 10 percent of GDP. This is assumed to be accompanied for two consecutive years by lower growth (by $-1\frac{1}{2}$ percentage points) and lower inflation (by $\frac{1}{2}$ percentage point). The primary balance is assumed to worsen by 14 percentage points of GDP in 2023, i.e., from costs to recapitalize the banking system or materialization of other contingent fiscal liabilities, such as calls on government guarantees. As a result, debt would rise to over 170 percent of GDP by 2024, and gross financing needs would be significantly higher.

19. [We also welcome staff's recommendations for the fiscal adjustment measures to be implemented from 2023. At the same time, we missed staff's clear assessment in the DSA whether Italy's public debt is sustainable under the current set of policies over different time horizons, in view of subdued growth prospects, rising borrowing costs, elevated sovereign spreads, and population aging.] Staff's comments would be appreciated.

- Over the forecast horizon, the public debt-to-GDP ratio is projected to decline under current policies to around the pre-Covid level, supported by still favorable automatic debt dynamics. While the public debt ratio is projected to increase again over the longer term due to higher pension spending and rising interest rates, a gradual fiscal consolidation path that brings the

primary surplus to about 2 percent of GDP by 2030, as recommended by staff, would put public debt on a firm downward path. Staff considers this adjustment scenario to be economically and politically feasible, as Italy has historically been able to maintain similar levels of primary surplus for extended periods of time. This would help achieve a level of debt that is consistent with an acceptably low rollover risk going forward and with preserving potential growth at a satisfactory level, confirming the sustainability of public debt. This point is illustrated in Box 3 of the report, where the Buffer Stock model baseline, in which the primary surplus converges to and then remains at 2 percent of GDP, results in a continuous decline in the public debt ratio.

20. While we appreciate the section on Policies for a Severe Scenario, analysis on the extent to which the very sharp growth downgrade staff envisioned would constrain authorities' ability to provide the recommended pandemic-era policy tools and relevant fiscal adjustment would have been useful to help understand the policy tradeoffs.

- The appropriate fiscal policy response to a very large negative output shock underscores the difficult tradeoff between the need for fiscal policy to stabilize activity and the risk that high public debt implies for financing costs. The IMF's Buffer Stock fiscal model is well suited to balancing these tradeoffs in an optimizing framework that incorporates: (i) two-way feedback between fiscal policy and output (multipliers and automatic stabilizers); (ii) hysteresis (recessions have persistent effects on output) and (iii) fiscal policy is constrained as debt reaches high levels because market access could be at risk.
- Therefore, while a comprehensive fiscal policy response would be needed, it should reflect Italy's much more constrained policy space. Pandemic-era type fiscal support would be required in this scenario to avoid an excessive output loss, limit social hardship and excessive business insolvencies, especially given the persistence of output effects (hysteresis). On the other hand, however, with high public debt and tighter financing conditions, the countercyclical fiscal response would need to be more limited than if public debt were considerably lower.

21. We encourage staff to point out that debt statistics are insofar incomplete as they do not record national shares in EU debt used for transfers.

- As has been the case in the past, when the European Commission contracts loans on behalf of the Union with the aim to on-lend to Member States, the borrowing is treated as EU debt. Such EU debt has corresponding EU assets in the form of a claim against the Member State to which the funds were on-lent (Eurostat, 2021, Guidance Note on the Statistical Recording of the Recovery and Resilience Facility).
- The novel element in the case of borrowing in the context of the NRRP is that part of the funds raised by the EU is used to finance grants to Member States, and contrary to loans, "there will be no direct claims on the Member States for this component" (paragraph 31, Eurostat 2021 Guidance Note).
- It is also noted therein that in this case, the repayments will be done through the EU budget. As a result, borrowing by the European Commission to finance grants from the NGEU fund is not recorded as part of the Member Countries' debt statistics.

ECB's Transmission Protection Instrument

22. Could staff shed more light on the so called “anti-fragmentation” tool or Transmission Protection Instrument (TPI) by the ECB, which according to financial experts, aims at mitigating divergence in borrowing costs in the eurozone, especially between weakest and strongest nations and how could this benefit Italy?
23. [We welcome the authorities’ conservative approach to budgetary projections and positively note that, despite increasing financing costs, the improved debt maturity profile will help to maintain the debt burden on a downward trajectory in the coming years, but close monitoring of financing costs will be of essence.] In this vein, could staff comment on the potential effects of the recently approved Transmission Protection Instrument by the ECB?
24. [Together with the move on the rates, the ECB also introduced a new policy instrument of Transmission Protection Instrument (TPI).] Could staff provide some initial thoughts on the impact of the TPI on Italian government’s borrowing cost and public debt dynamic, as the central banks have already held around 30 percent of its sovereign bonds.
25. Could staff also elaborate on the prospects of using a new Transmission Protection Instrument in the ECB toolkit for purchases of Italy’s sovereign bonds?
- On July 21, alongside its decision to raise key policy rates, the ECB announced the introduction of a new tool, the Transmission Protection Instrument (TPI). TPI would be activated to counter unwarranted, disorderly market dynamics that seriously threaten the transmission of monetary policy across the euro area, thereby allowing the ECB to more effectively deliver its price stability mandate. The key characteristics of the tool include:
 - **Disorderly market dynamics:** TPI activation will be based on an assessment of market and transmission indicators, an evaluation of eligibility criteria and a judgement that the activation of purchases under the TPI is proportionate to the achievement of the ECB’s price stability objective. No specific triggers for activation were announced.
 - **Eligibility criteria:** Countries must satisfy the following criteria: (1) not being subject to an excessive deficit procedure, or assessed as having failed to take effective action recommended by the European Council; (2) not being subject to an excessive imbalance procedure or not being assessed as having failed to take the recommended corrective action; (3) having sustainable debt dynamics based on DSAs conducted by the European Commission, the European Stability Mechanism, the International Monetary Fund, and other institutions, together with the ECB’s internal analysis; and (4) complying with the commitments under the Recovery and Resilience Plan and the European Commission’s country-specific recommendations.
 - **Size:** The size of the TPI will not be restricted ex ante. Nonetheless, purchases will depend on the severity of the risks facing monetary policy transmission.
 - **Other operational considerations.** Purchases will target public sector securities with a remaining maturity of 1–10 years while private sector securities could be considered, if

appropriate. TPI purchases would be conducted such that they have no persistent impact on the Eurosystem balance sheet and hence the monetary policy stance. Flexible reinvestment of PEPP assets remains the first line of defense against risks to transmission related to the pandemic.

- The introduction of a new instrument to fight fragmentation can be seen as increasing the ECB's scope to pursue monetary policy normalization. The unlimited size of the instrument ex ante is a strong signal to markets, while the constructive ambiguity regarding the TPI's triggers avoids providing markets a limit to put to the test. Activation of the TPI requires the ECB Governing Council to make a determination that a tightening of financial conditions is due to unwarranted, disorderly market dynamics. Italy's spread vis a vis the German bund has widened in recent weeks in response to political developments. As noted by Governor Visco, Italy's current elevated spreads reflect the uncertain policy environment.
- Ultimately, however, a country's spreads are shaped by its debt ratio. Permanently lifting growth and the primary balance would lower Italy's risk premium and create a virtuous cycle that supports faster debt reduction and lower rates.

Financial

26. [We also note that the end-2021 deadline for selling state-owned bank Monte dei Paschi was missed.] We would be grateful for further information from staff, including on the implications that this has for public finances.

- Monte dei Paschi (MPS), the fifth largest bank in Italy and the oldest bank in the world, benefited from State recapitalizations in 2009 and 2013, which were both repaid. In 2017, approved by European Commission in consistency with state aid rules, MPS received a precautionary recapitalization from the Italian government after failing to raise sufficient capital from private investors. This injection cost the State €5.4 billion and gave the Italian government a 64 percent stake in the bank. As agreed with the European Commission, the state ownership was to be divested by end-2021.
- This divestment deadline was not met following unsuccessful negotiations on a sale to UniCredit in the second half of 2021. The government is currently seeking to extend the deadline to sell MPS and is expected to agree on a new timeline by later this year, according to the authorities. In June 2022, MPS announced plans to raise €2.5 billion in capital by the end of the year, including around €1.6 billion from the State. The new plan involves reorganization of the banking group, including merging with three previously separate MPS capital and IT service companies, and establishing new leadership roles within the group overseeing SME loans and managing operating costs. The bank will also close down 150 (11 percent) branches and reduce about 4,200 staff, in addition to improving digitization and further reducing NPLs.
- MPS's weak business model and relatively concentrated and low-quality loan portfolio have challenged the bank's recent restructuring efforts. Not closing down a bank that suffers from long-term business viability issues may be seen as helping to protect local employment in the short term, but could create a large fiscal burden in the longer term (including through additional capital injections and fiscal incentives). In addition, this could create moral hazard by setting expectations of future support within the banking sector. Consideration of these

potentially high long-term costs should be factored in when deciding how to address banks with structurally weak business models.

Climate

27. Could staff comment on how the delayed phaseout of coal power plants would impact Italy's climate goals?

- Italy's contingency plan under the scenario of the full shut-off of the Russian gas imports includes delaying the retirement of several coal plants that are expected to generate 15 TWh of additional electricity output annually, thereby freeing up gas for other uses. This is equivalent to a net increase of about 8 million tons of CO₂ emissions (2 percent of Italy's total annual emissions), calculated as emissions from coal less emissions "saved" by not using gas to generate this amount of electricity. As a result, Italy's progress in achieving emission reduction targets will be delayed, but only temporarily as the coal plants will be retired in 2–3 years as the new alternative supplies of gas come online. Nonetheless, unless offset in the future, Italy's total cumulative carbon emissions will have increased.

28. [As noted by the authorities, in addition, reduction of carbon emissions through a carbon tax will require a coordinated EU approach, with due consideration given to distributional impacts.] We would appreciate staff comments on their expectations for such coordinated action by the EU.

- The EC's proposed "Fit for 55" package introduces a separate emissions trading system (ETS) for the transport and building sectors, which would expand carbon pricing to the vast majority of emissions. A revision of the Energy Tax Directive is also envisaged, laying out the basis for increases of effective carbon taxation by realigning excise taxes on fuel in line with their carbon content. The proposed measures also include establishing a new Climate Action Social Fund to reduce the adverse impact of higher carbon prices on lower-income households and finance investments in energy efficiency, heating and cooling systems, and cleaner transport for households. The Social Fund would be financed by recycling revenues generated by the expanded ETS (with the exact share still under discussion) and matched by Member States' domestic resources.
- In June 2022, the European Parliament considered eight legislative proposals that are part of the EU's "Fit for 55" package. However, the key reforms to the ETS, including those on the timing of the phasing out of free allowances, the steeper emission reduction pathway, and the extension of emission permits to transport and buildings were all voted down. This could delay legislation of the "Fit for 55" package beyond the targeted date of end -2022. Meanwhile, the Members of European Parliament voted to ban the sale of new petrol and diesel cars by 2035, raise the target on national emissions reduction under the Effort Sharing Regulation, increase the goal of new carbon sinks, and expand the coverage of the ETS to all flights departing from European Economic Area airports, including international flights. The "Fit for 55" package is key to operationalizing the emission reduction targets set out in the EU Climate Law. Reaching a compromise in order to push forward the full legislative package would help ensure decarbonization targets are met within a coordinated EU framework.

- Additionally, the REPowerEU package proposes to increase the EU's target for renewable electricity generation to 45 percent from the previous 40 percent of total electricity production by 2030. This would also offset the impact of higher coal use in the near-term as the annual GHG emissions reduction target would be unchanged in 2030 relative to the "Fit for 55" target. The package includes measures to promote additional solar, green hydrogen and biomethane gas (including to streamline and set out good practices for permitting procedures at the national level, and address ambiguities in the application of EU legislation).

29. We would be interested in concrete policies that could be recommended in the absence of an EU-coordinated approach on carbon taxation, especially in the context of Italy's already very high energy taxation.

- A coordinated approach to reducing carbon emissions across the EU is preferable to ensure equitable burden sharing and a level playing field. Absent such coordination, a country that unilaterally pursues more restrictive climate policies could be at risk of losing competitiveness vis a vis EU peers in the context of intra-EU and extra-EU trade.
- That said, within existing EU climate policies, Italy has plenty of scope to improve its climate policies with minimal—if any—impact on its competitiveness. This can be achieved through *smarter* climate policies that can generate greater carbon reduction without raising overall energy taxes:
 - Specifically, current taxation of energy products is disconnected from the carbon (and other pollutants) contained in the fuel source. Setting energy taxes based on their carbon content, and with carbon taxes equalized across fuel sources, would equate marginal abatement costs. This implies that per unit of energy output, coal should be taxed more heavily than oil, and with oil taxed more heavily than gas. In addition, high taxes on electricity consumption—which do not differentiate between green or carbon-emitting energy sources—should be replaced with taxes on the carbon emitted in the process of generating electricity with fossil fuels. These energy tax changes can be implemented in a revenue neutral manner.
 - In addition, fiscal subsidies should be made much more cost effective. The implicit cost of abating a unit of carbon through existing subsidies on electric vehicles or tax incentives for building refurbishment are many multiples of the current price of carbon in the ETS. While no longer being granted since 2013, large subsidies to renewable electricity generation capacity are not needed to encourage new capacity given the sharp decline in costs over the past decade. More strategic use of subsidies—while also lowering the overall fiscal cost from the current 2 percent of GDP per annum—could deliver larger reductions in emissions with much greater cost effectiveness.
- Further streamlining approvals procedures for pending projects in renewable electricity capacity requires minimal direct fiscal cost. However, cumulative future cost savings for the private sector in terms of avoiding the need to purchase carbon permits can be very significant.

Structural Issues

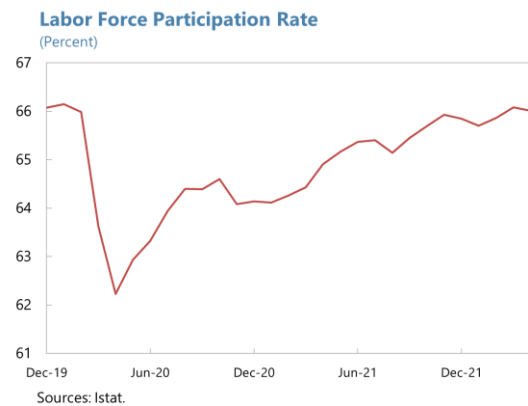
30. Could staff elaborate on the challenges faced by the authorities and corrective strategies in place to effectively implement these complex reforms and public investment programs.

31. Staff comments on the implications of not implementing the reform and investment plans under the NRRP would be welcome.

- The authorities are undertaking a large number of reforms to ensure the full and efficient implementation of the NRRP. In the public administration, this entails establishing units responsible for implementation, coordination with sub-national governments, tendering, oversight and reporting. To operationalize this plan, the temporary hiring of technical staff is underway. These efforts are being implemented to overcome Italy's legacy of incomplete reforms and slow utilization of structural funds (see for example, [IMF WP 2020/40](#)) due to difficulties in maintaining political momentum for structural reforms. Nonetheless, implementation is subject to challenges, including sharply rising input costs and shortages of materials, difficulties hiring sufficient well-qualified staff, especially in the North where living costs are high, and ensuring responsibilities delegated to local governments are efficiently implemented.
- The NRRP is a concerted, multi-faceted, and front-loading reform push. Given the complementarity of reform benefits (see selected issues paper, *Productivity in Italy*), moving ahead on a broad reform agenda is likely to yield larger benefits. In addition, this approach is likely to be more effective than piecemeal reforms in part because in the case of standalone reforms, beneficiaries tend to be a diffuse group while losers are a concentrated lobby. However, when reforms are comprehensive, these groupings are less clear cut, potentially making it more difficult to stage a challenge to the reforms.
- The NRRP has the potential to lift Italy's labor productivity and potential growth. A speedy resolution of political uncertainty is needed to ensure timely implementation of the Plan's reforms and investments. Delays in delivering milestones and targets would delay receipt of EU funds needed to support demand during a period of significant growth headwinds. In addition, diluting the reforms would severely reduce the future benefits for potential growth. This would have implications for public debt dynamics and government borrowing costs.

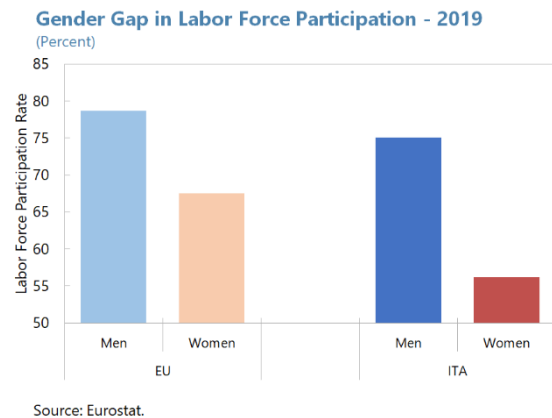
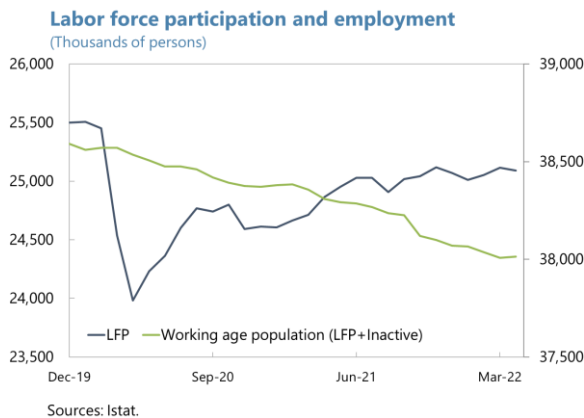
32. On the labor market, could staff further elaborate on the outlook for the labor force participation rate in light of the NRRP implementation and associated reforms?

- The labor force participation (LFP) rate has almost fully recovered from the pandemic shock. However, the number of people in the workforce is still well-below the pre-COVID level and the recovery in the LFP rate was, in part, driven by the decline in the working age population (likely on net emigration). Nonetheless, Italy's LFP has historically been very low, especially for women and the young. More specifically, the gender



gap in labor force participation has been relatively large (19 percentage points, compared to the EU average of about 11 percentage points), and there has also been a significant number of young Italians not in employment, education, or training (with a NEET rate of about 20 percent, nearly double the EU average).

- The NRRP's Mission 5 is dedicated to "inclusion and cohesion" to facilitate labor market participation—including through training, strengthening active labor market policies, as well as fostering social inclusion through measures for female entrepreneurship and investment in social infrastructure to support children and elderly care (e.g., expansion of childcare facilities and temporary housing with care services for the disabled and the elderly). This should help bring the inactive population into the workforce. In addition to this, other NRRP-related reforms would also be essential to reduce or reverse net emigration by strengthening the business environment and thus raising growth and employment prospects.



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OEDSA

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