INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 09/16
FOR IMMEDIATE RELEASE
February 6, 2009

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2008 Article IV Consultation with Italy

On February 6, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Italy.[1]

**Background**

The economy has entered into recession, as the global financial crisis and ensuing slowdown intensified. Output is projected to contract by 0.6 percent in 2008 and 2.1 percent in 2009, with risks tilted to the downside. Inflation has moderated, in line with the euro area, and is expected to decline further in 2009 as the output gap increases. The current account deficit is projected to moderate to 2.4 percent of GDP in 2008 and 2 percent of GDP in 2009 and then gradually narrow over the medium term, as external demand and exports pick up. The economy's recovery, however, is likely to be slow and weak, reflecting underlying structural rigidities, lack of domestic competition, and the limited scope for a fiscal response.

The financial system has weathered the global turbulence, although vulnerabilities have increased. While banks came under pressure, the system as a whole remained solid, and no institution failed or fell short of regulatory requirements. The system's resilience reflects its relatively safer risk profile, which was supported by a firm regulatory and supervisory environment, strong intervention and resolution frameworks, and pre-existing high levels of depositor protection. However, vulnerabilities have risen, related to banks' capitalization, funding, credit quality, profitability, and exposure to Central and Eastern Europe (CEE).

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The revenue-based fiscal consolidation has come to an end. The structural fiscal balance improved by 2¾ percent of GDP in 2006-07, mainly due to exceptionally strong revenues, with the overall deficit narrowing to 1.6 percent of GDP in 2007. But, reflecting the expansionary budget, weaker revenues, and some temporary factors, the deficit likely rebounded to 2¾ percent of GDP in 2008, entailing a loosening in structural terms and a higher expenditure ratio, with the primary current spending ratio reaching a record high. The fiscal deficit is likely to widen to around 3.9 percent of GDP in 2009, due to the deteriorating macroeconomic environment. Debt will start rising again, reaching 109 percent of GDP in 2009.

**Executive Board Assessment**

The Executive Directors noted that, in line with the rest of the euro area, Italy is being severely affected by the worsening economic environment, although its financial sector has remained relatively resilient. The economic recession is deepening, and, while a gradual recovery is expected in 2010, the possibility of a prolonged downturn cannot be ruled out. Against this backdrop, Directors welcomed the authorities' focus on prudent and comprehensive measures to strengthen financial stability and on temporary and targeted fiscal measures, while remaining committed to fiscal sustainability. They underscored the need to implement these measures promptly. At the same time, the authorities should step up implementation of their long-run structural reform agenda to enhance the economy's growth potential.

Directors supported the authorities' actions to strengthen financial system stability and reduce vulnerabilities through intensified monitoring and prudential oversight. They looked forward to the implementation of the recently announced voluntary government recapitalization scheme, while stressing the need for minimizing potential negative spillovers for other countries. Directors commended Italy's advocacy of enhanced international regulatory and supervisory coordination.

Directors supported the government's anti-crisis fiscal package. The package takes into account the limited room for fiscal stimulus, and focuses on temporary, targeted, and timely measures, as well as on accelerating public investment projects. Directors in general saw little scope for further stimulus, but a few noted that a somewhat larger stimulus could be considered if the growth outlook deteriorates further. Although a delay in structural consolidation is warranted for 2009, it will nevertheless be important to carry out the envisaged reductions in current spending to underpin fiscal sustainability. In this vein, Directors welcomed that the authorities remain committed to attaining fiscal balance in the medium term.

Directors welcomed the progress made in improving Italy's fiscal frameworks. The 2009 budget process has been streamlined and its medium-term orientation strengthened. Efforts are under way to increase the productivity of public administration and improve the management of public assets. Implementation of the fiscal federalism reform will increase fiscal autonomy and discipline at all levels of government. Directors encouraged the authorities to build on these efforts, by filling the remaining gaps, and following through on plans to tackle longer-term fiscal challenges, in particular reforming the welfare system.

Directors underscored the importance of reducing regulation, increasing competition, and improving the business environment to raise Italy's productivity and growth potential. They welcomed recent measures to enhance competition in local public services, simplify legislation, and institute competition assessments and regulatory impact analyses. Directors called on the authorities to further liberalize retail trade and services, continue deregulation in the energy market, and strengthen the role of competition bodies. A comprehensive package could help reinvigorate the reform effort by reaping synergies and raising popular support.

Directors noted the strides made in the past decade to boost employment. They encouraged a second generation of labor market reforms to strengthen the link between wages and productivity, allow wages to better respond to regional differences, and make permanent contracts more flexible, in tandem with efforts to enhance the social safety net. Directors pointed to the benefits that would accrue from concerted efforts to attain the EU Lisbon Agenda objectives, and urged the authorities to resist protectionist pressures.

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## Summary of Economic Indicators

(Annual percentage change, unless noted otherwise)

| | 2005 | 2006 | 2007 | 2008 1/ | 2009 1/ | Latest reading (period percentage change, unless noted otherwise) | |
|---|---|---|---|---|---|---|---|
| Real GDP | 0.6 | 1.8 | 1.5 | -0.6 | -2.1 | -0.5 | 2008Q3 |
| Public consumption | 1.9 | 0.8 | 1.2 | 1.0 | 0.9 | 0.0 | 2008Q3 |
| Private consumption | 0.9 | 1.1 | 1.4 | -0.4 | -0.4 | 0.1 | 2008Q3 |
| Gross fixed capital formation | 0.7 | 2.5 | 1.2 | -1.9 | -7.8 | -1.9 | 2008Q3 |
| Final domestic demand | 1.1 | 1.3 | 1.4 | -0.4 | -1.7 | -0.5 | |
| Stock building 2/ | -0.2 | 0.5 | -0.1 | 0.3 | 0.6 | -0.1 | |
| Net exports 2/ | -0.3 | 0.0 | 0.1 | 0.3 | -0.3 | -0.3 | 2008Q3 |
| Exports of G&S | 1.0 | 6.2 | 5.0 | -1.3 | -3.2 | -1.6 | 2008Q3 |
| Imports of G&S | 2.2 | 5.9 | 4.4 | -2.4 | -2.3 | -0.5 | 2008Q3 |
| Money and credit (end of period, percent change) | | | | | | | |
| Private sector credit 3/ | 7.7 | 11.0 | 9.8 | 7.3 | ... | 5.9 | Oct-08 |
| National contribution to euro area M3 4/ | 6.3 | 7.7 | 7.6 | 10.8 | ... | 7.8 | Oct-08 |
| Interest rates (in percent, end of period) | | | | | | | |
| 6-month interbank rate 5/ | 2.6 | 3.8 | 4.9 | 4.3 | ... | 4.3 | Nov-08 |
| Government bond rate, 10-year 5/ | 3.5 | 4.2 | 4.7 | 4.7 | … | 4.7 | Dec-08 |
| Resource utilization | | | | | | | |
| Potential GDP | 1.2 | 1.3 | 1.1 | 0.6 | 0.5 | | |
| Output Gap (% of potential) | -0.8 | -0.2 | 0.2 | -0.9 | -3.4 | | |
| Natural rate of unemployment | 7.6 | 6.8 | 6.1 | 6.6 | 7.1 | | |
| Employment | 0.7 | 1.8 | 1.0 | 0.3 | 0.1 | | |
| Unemployment rate (%) | 7.7 | 6.8 | 6.1 | 6.8 | 7.3 | | |
| Prices | | | | | | | |
| GDP deflator | 2.1 | 1.7 | 2.3 | 3.1 | 2.3 | 2.9 | 2008Q3 |
| Consumer prices | 2.2 | 2.2 | 2.0 | 3.5 | 1.2 | 4.1 | 2008Q3 |
| Manufacturing | | | | | | | |
| Hourly compensation | 4.6 | 2.9 | 2.5 | 5.5 | 1.7 | 3.7 | 2008Q3 |
| Productivity | 0.5 | 0.2 | 0.4 | -0.9 | -1.0 | -0.8 | 2008Q3 |
| Unit labor costs | 4.1 | 2.7 | 2.1 | 6.4 | 2.7 | 7.5 | 2008Q3 |
| Fiscal indicators 6/ | | | | | | | |
| General government balance | -4.2 | -3.4 | -1.6 | -2.7 | -3.9 | | |
| Structural balance (in % of potential GDP) | -4.0 | -3.3 | -1.8 | -2.2 | -2.1 | | |
| Public debt ratio | 105.8 | 106.9 | 104.1 | 105.6 | 109.4 | | |
| Exchange rate regime | | | | | | | |
| Exchange rate (NC/US$) | 1.2 | 1.3 | 1.4 | 1.5 | 1.5 | 1.3 | Oct-08 |
| Nominal effective rate: CPI based (2000=100) | 107.3 | 107.8 | 109.9 | ... | ... | | |
| Real effective exchange rate based on | | | | | | | |
| CPI (2000=100) | 112.1 | 111.8 | 113.2 | ... | ... | | |
| normalized ULC (2000=100) | 132.0 | 134.0 | 138.7 | 145.0 | 143.7 | | |
| External sector 6/ | | | | | | | |
| Current account balance | -1.7 | -2.6 | -2.5 | -2.4 | -2.0 | | |
| Trade balance | 0.0 | -0.7 | 0.1 | 0.1 | 0.4 | | |
| Saving investment balance 6/ | | | | | | | |
| Gross national saving | 19.1 | 18.9 | 19.0 | 19.1 | 18.6 | | |
| Public | -0.6 | 1.3 | 2.3 | 1.0 | -0.2 | | |
| Private | 19.7 | 17.6 | 16.7 | 18.2 | 18.8 | | |
| Gross domestic investment | 20.8 | 21.5 | 21.5 | 21.5 | 20.6 | | |
| Gross fixed domestic investment | 20.7 | 21.0 | 21.1 | 20.5 | 19.3 | | |
| Public | 4.3 | 4.2 | 3.9 | 4.1 | 4.1 | | |
| Private | 16.4 | 16.8 | 17.1 | 16.4 | 15.2 | | |
| Net lending | -1.7 | -2.6 | -2.5 | -2.4 | -2.0 | | |

Sources: National Authorities; and IMF staff calculations.

1/ Staff estimates and projections, unless otherwise noted.

2/ Contribution to growth.

3/ Twelve-month credit growth, adjusted for securitizations. 2008 data refer to Sept.

4/ Excludes currency in circulation held by nonbank private sector. 2008 data refer to Sept.

5/ Data for 2008 refer to Nov. on 6-month interbank rate, and Dec on Government bond rate.

6/ Percent of GDP.