FOR AGENDA

SM/10/127
Correction 1

May 24, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Italy—Staff Report for the 2010 Article IV Consultation**

The attached corrections to SM/10/127 (5/12/10) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 5, para. 6, line 5: for "loans increased by 40 percent"
read "loans increased by around 40 percent (from a low base)"
para. 7, line 6: removed "(the so-called "*Tremonti Bonds*")"

Page 7, para. 12, line 6: removed "("*Tremonti Bonds*")"

Page 9, para. 15, line 8: for "This fiscal deterioration was largely in line with that in the euro area"
read "The resulting deficit was better than the euro area average, although the deterioration in terms of the change in the structural primary balance was similar"

Page 11, Text table: "Italy: Comparative Growth Forecasts", row "IMF/WEO":
for "Jan-10" read "Apr-10"

Page 15, Text table: "Italy: Finance Law—Summary of Main Budget Interventions", row "FAS (Local development fund)":
revised to read "FAS (Fund for Underutilized Areas)"

Page 16, fourth bullet, Text chart: for "EEA-12" read "EA-12"

Page 19, para. 33, line 5: added "(EC)"
para. 34, line 1: for "The projections assume"
read "The projections, while based on the commonly applied EC assumptions, assume"

Page 20, Figure 5: added note "1/ Estimates are based on the 2009 Ageing Report and do not reflect subsequent official revisions."

Page 24, para. 42, line 10: for "*Tremonti bonds*"
read "the recapitalization bonds"

Page 28, Figure 6: corrected numbering on the right side axis of the second chart

Page 32, Table 1, row "External sector 6/": revised to read "External section 5/"
"Sources": added "Eurostat" and "(April 2010 WEO)"

Page 33, Table 2, row "GDP growth rate 2/", column 6: for "2.2"
read "1.1"
column 8: for "2.9"
read "2.0"
column 11: for "3.4"
read "2.0"
row "Public debt": removed entries in column SP-T for 2011 and 2012
"Sources": added "(April 2010 WEO)"

Page 34, Table 3, row "Nonperforming loans": revised to read "Nonperforming loans 1/"
row "Net of provisions, percent of capital": removed
row "Leverage 1/": revised to read "Leverage 2/ 3/"
for note "1/ Tier 1 capital on assets" read "2/ Assets on tier 1 capital"
added note "1/ Bad debts plus substandard loans."
added note "3/ Not in percent."
"Sources": removed "Eurostat"

Page 40, second para., line 6: removed "The fiscal position…has been increasing."
Footnote 6, line 1: removed "This presentation…accounting treatment."
line 3: for "The financial position of the SSN, in particular, has improved"
read "The financial position of the National Health Service (*Servizio Sanitario Nazionale, SSN*) has however improved"

Page 41, Text chart: removed right panel

Page 42, fourth paragraph, line 5: for "them more administrative"
read "them administrative"

Page 43, Box 1, line 12: added "(63 for the self-employed)"

Page 55, Table 2A, Note 4/: added "The age requirement is one year higher for the self-employed. A further postponement of about 9–12 months is envisaged through the "exit windows"."

Page 79, References, line 7: for “IMF Working Paper …/10”
read “Forthcoming IMF Working Paper”

Page 119, Table, “Sources”: added “Eurostat” and “(April 2010 WEO)”
removed note 4/

Questions may be referred to Mr. Spilimbergo (ext. 36346) and Mr. Bennett (ext. 35345) in EUR.

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Att: (20)

Other Distribution:
Department Heads

B. The Global Crisis (2008–2009)

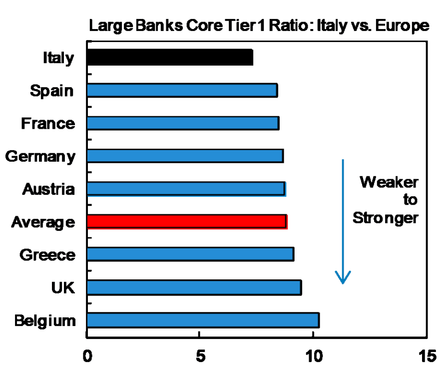
Despite the comparatively resilient financial system and the lack of a domestic credit/housing boom/bust, output fell sharply as trade and investment slumped.

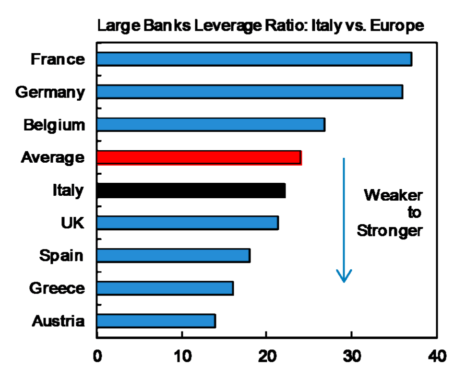
Financial sector: resilient

5. **Banks proved resilient to the initial phase of the global financial crisis.** The banks benefited from a business model based on classical on-balance sheet lending-deposit activity, and strong customer relationships. With adequate liquidity and the absence of asset bubbles and toxic assets, this conservative business model sheltered Italian banks from the liquidity crunch at the onset of the crisis. Unlike elsewhere, Italian banks did not need emergency government intervention and recourse to ECB liquidity support schemes remained limited.

6. **The subsequent deterioration of the economy nevertheless weakened banks' asset quality and profitability.** Credit risk increased during the second half of 2008 and deteriorated rapidly in 2009. Following the economic contraction, lending growth to the private sector slowed sharply, profitability declined, and asset quality deteriorated. In 2009, the stock of nonperforming loans increased by around 40 percent (from a low base) with respect to the previous year. Loan loss provisions for the 5 largest banks (as a percentage of pre-provision earnings) increased from about 30 percent in 2008 to about 56 percent in 2009, which was in line with the European average.

7. **Banks increased capitalization in 2008–09, but their capital ratios still range from weak to average compared with other countries in Europe.** Capitalization had weakened to just-adequate levels before the crisis. Since the crisis, banks were able to recapitalize by raising capital from core shareholders, selling nonstrategic assets, and cutting dividends (often to zero). Some banks also issued government-sponsored recapitalization bonds. Despite recent strengthening in capitalization, Italian banks still display weaker Core Tier1 ratios than their European peers. The comparison is more favorable if the leverage ratio (defined as the ratio between assets and equity) is taken into consideration.





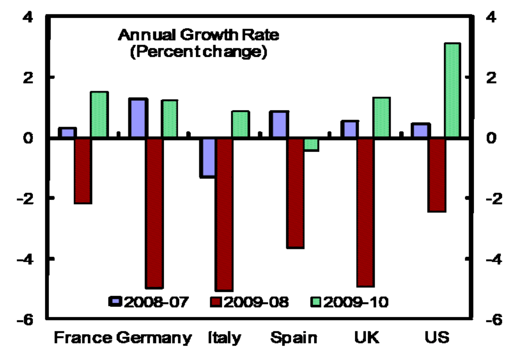
Source: IMF staff calculations on Company Reports. 2009 data.

8. **Other financial institutions have also weathered the global financial crisis relatively well.** The Italian insurance industry was little exposed to the crisis, with issuer defaults amounting to ½ percent of technical reserves. In 2009, premium revenues increased, and in the first semester, the insurance sector recorded a profit. Most pension funds had positive (albeit low) returns in 2009, often offsetting the losses recorded in 2008. The profitability of asset management companies, investment firms, and financial companies fell, but remained positive, in 2008.

Real Sector: adversely affected by the global crisis

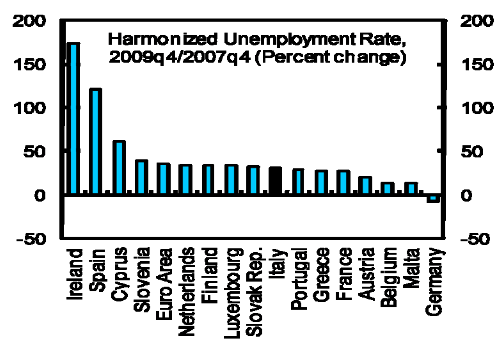
9. **The global financial crisis affected the real economy mainly through trade, credit, and confidence channels.** The recession in Italy's main trading partners led to a sharp fall in exports. Financing conditions tightened and credit growth fell, both to households and corporates, reflecting a combination of lower perceived borrower creditworthiness and a fall in loan demand. Corporate leverage increased, bankruptcies rose, and the profit share fell. Market indicators of expected corporate default spiked in 2009 and still remain above pre-crisis levels. Despite strong household balance sheets, private consumption declined significantly, reflecting rising unemployment and tighter consumer credit, only marginally offset by the weak rise in government consumption. Gross fixed investment and inventories also fell sharply, reflecting weak demand prospects and difficult financing conditions.

10. **The global crisis triggered Italy's worst recession since World War II.** The downturn in Italy started earlier and lasted longer than in most of its euro area peers. Italy's reliance on exports and the predominance of SMEs increased its vulnerability to a global downturn. Additionally, the weak initial conditions and the decision not to engage in a large fiscal stimulus (which was appropriate in view of the high level of public debt) translated into one of the deepest output falls among large industrialized countries. Despite the sharp output fall, inflation and wage growth remained above the euro area average. Combined with falling productivity growth, this further worsened unit labor costs and squeezed profit margins.



Sources: OECD; and WEO.

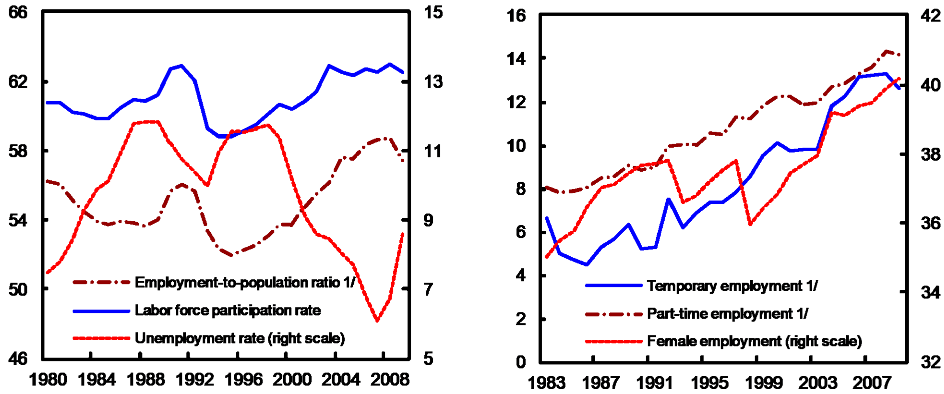
11. **Unemployment increased, though relatively mildly.** Unemployment rose to 8.3 percent in the fourth quarter of 2009, 1.9 percentage points increase from end 2007, much lower than in most of its euro area peers. While this partly reflects falling participation, Italy, like Germany and France, relied on temporary lay-off and work



Source: Eurostat.

reducing measures. In particular, the government provided additional wage supplementation funds (*Cassa Integrazione Guadagni*, or CIG) to sustain labor demand.

Recent Labor Market Trends in Italy



Sources: Istituto Nazionale di Statistica; and Eurostat.
1/ Latest observation is as of 2009q3.

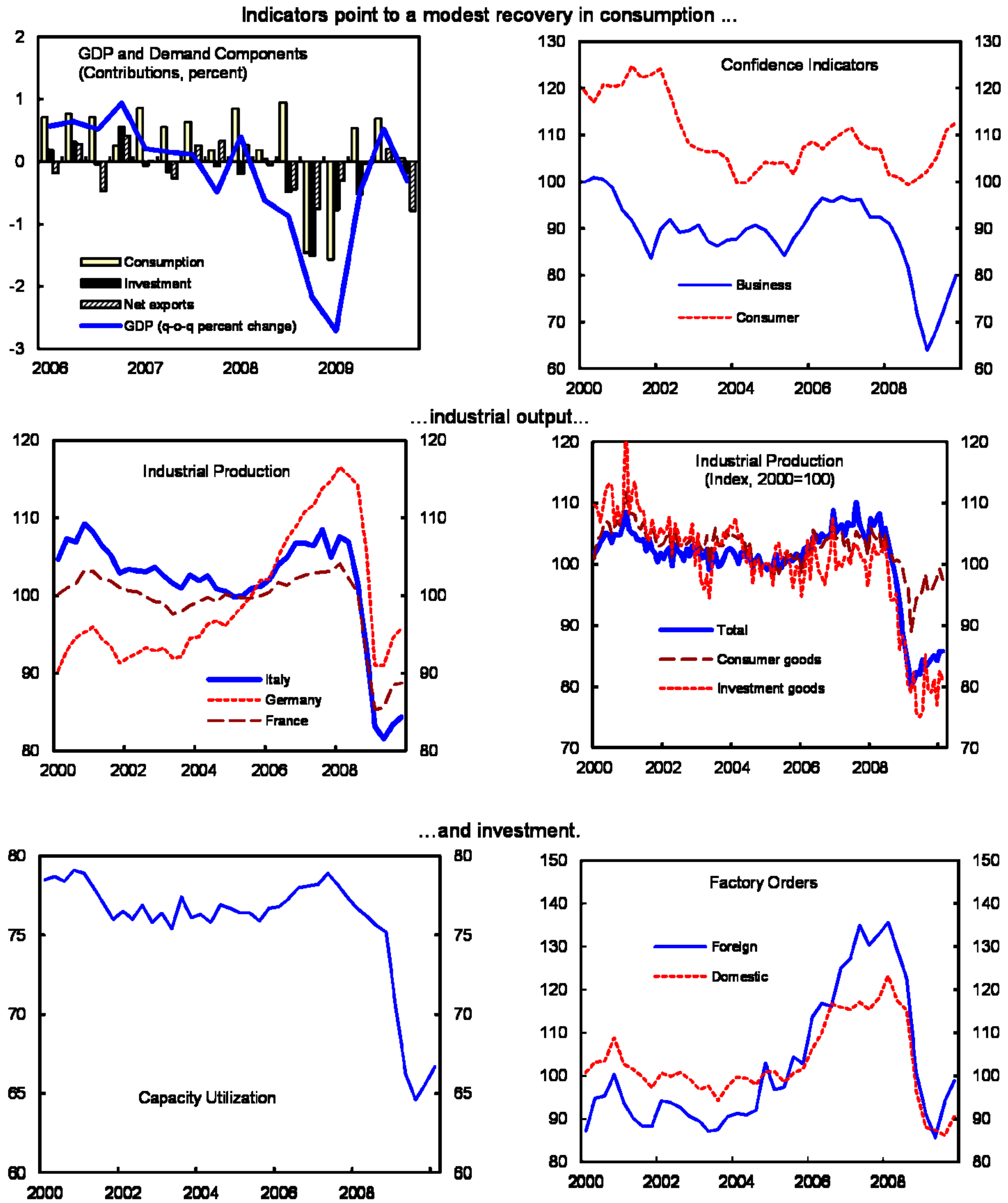
Response to the crisis: supportive but modest

Financial sector

12. **The authorities helped the financial sector weather the crisis through a range of measures.** The government guaranteed the deposit insurance fund; several instruments were established to improve bank liquidity, including a state guarantee for new bank liabilities, a facility for swapping bank assets or bonds issued by banks for government securities and a system for anonymous but collateralized interbank lending. The government also offered a recapitalization scheme, although this was used by only four banks (for a total of €4.05 billion recapitalization bonds, or less than half the €10 billion that was made available). The modest uptake of the scheme mainly reflected the conditionality as well as the recovery in global financing conditions which was already underway when the scheme was launched.

13. **Government policies also focused on supporting credit to the private sector, especially to small- and medium-sized enterprises (SMEs).** Besides exerting moral suasion on financial institutions, a state-controlled financial institution (*Cassa Depositi e Prestiti*, CDP) made funds available to banks that extend credit to SMEs, the existing guarantee fund for SMEs has been strengthened, and the Ministry of the Finance is overseeing a bank loan moratorium agreement between the banking association and the employers' federation, which has allowed the suspension of loan repayments for €9 billion (0.6 percent of GDP). The government is also setting up a recapitalization fund for SMEs, financed by the government, the CDP, the employers' federation, and private banks.

Figure 2. Economic Recovery is Underway

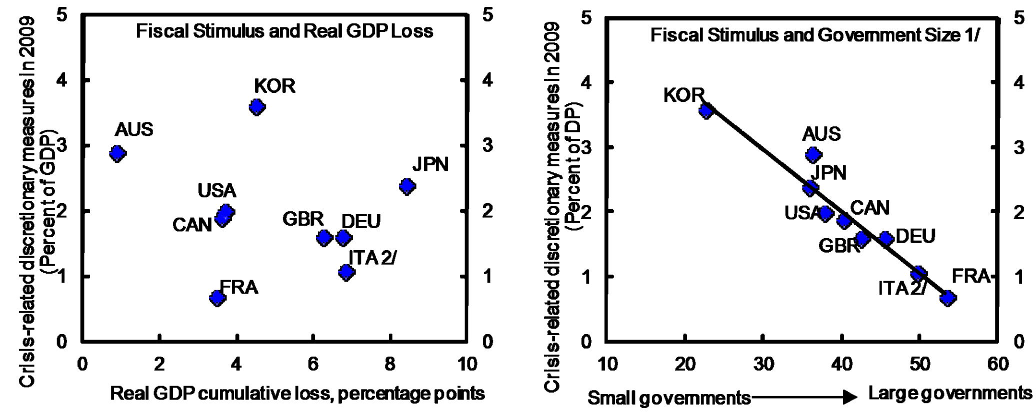


Sources: Istituto Nazionale di Statistica; and ISAE.

Fiscal policy

14. **The high level of public debt constrained the government's ability to implement discretionary countercyclical fiscal policy.** Italy's stimulus package included facilitating access to credit for small and medium-sized enterprises (SMEs), a car scrapping program, a one-off family bonus, and wage supplementation schemes. Overall, this was one of the smallest stimulus packages among advanced G–20 countries, reflecting the limited fiscal space available, the existence of large automatic stabilizers, and concerns that the market might have reacted adversely to an expansionary fiscal stance.

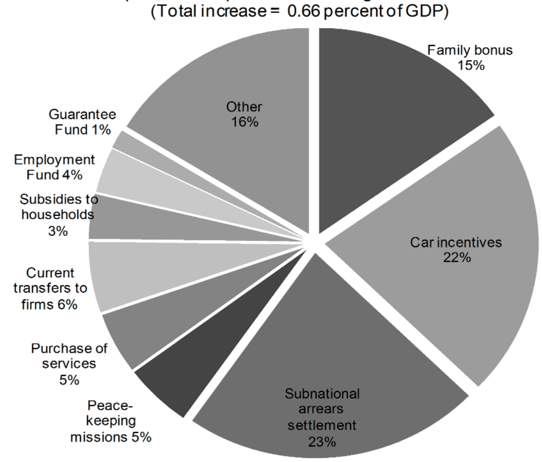
Italy's real GDP loss has been one of the highest in the advanced G-20 countries, but the already large size of the government appeared to be a dominant factor for the size of the fiscal stimulus.



Sources: WEO database; and IMF staff estimates.
1/ General government expenditure, percent of GDP (average over 2005-09).
2/ For Italy, estimated gross fiscal impact of revenue reducing and expenditure increasing measures is used, adjusted for the end-2009 postponement of the part of income tax payment and actual utilization of the one-off family bonus and the car scrapping scheme in 2009.

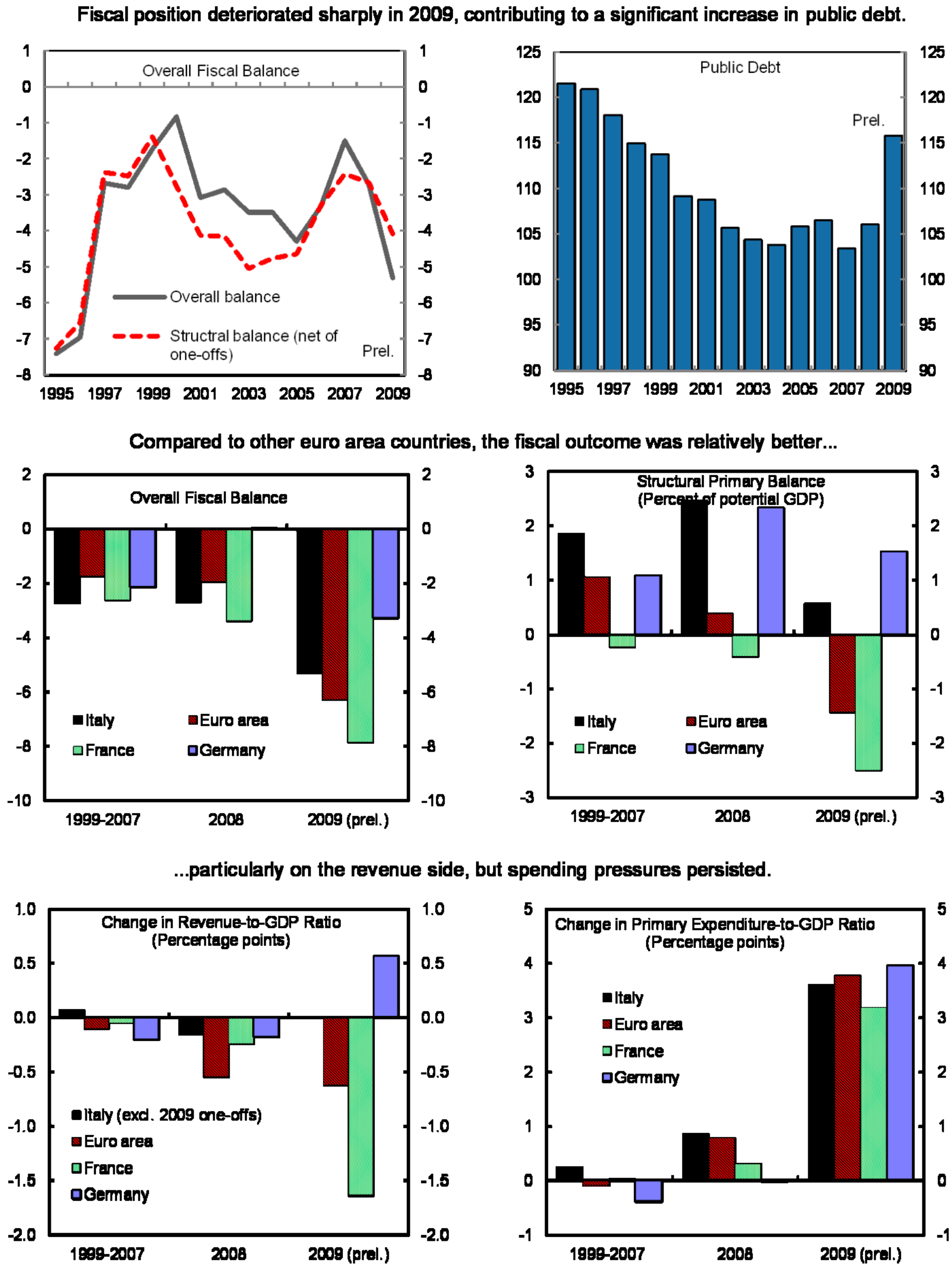
15. **Although the fiscal stimulus was small, the fiscal position deteriorated sharply in 2009.** Public debt increased by about 10 percentage points of GDP in 2009, reaching 115.8 percent of GDP. The overall deficit is estimated to have reached 5.3 percent of GDP, an increase of over 2½ percentage points from 2008. The resulting deficit was better than the euro area average, although the deterioration in terms of the change in the structural primary balance was similar (Figure 3). Total revenue remained robust, unlike in other countries, largely because of one-off capital tax receipts (about ¾ percent of GDP, including those resulting from a tax amnesty), which offset a slump especially in indirect and corporate income taxes. However, primary expenditure rose sharply because of increased social transfers and outlays on goods and services (including defense spending).

Composition of expenditure inceasing measures in 2009
(Total increase = 0.66 percent of GDP)



Source: Ministry of Economy and Finance.

Figure 3. Italy: Fiscal Overview, 1995–2009
(Percent of GDP, unless otherwise indicated)



Sources: ISTAT; WEO; and IMF staff estimates.

Political context

16. **The center-right government that came to power in May 2008 is likely to see out its full term ending in 2013.** The government retains a handsome majority, and its popularity was confirmed by the outcomes of recent local elections**.**

II. Outlook: A Modest and Fragile Recovery

Baseline

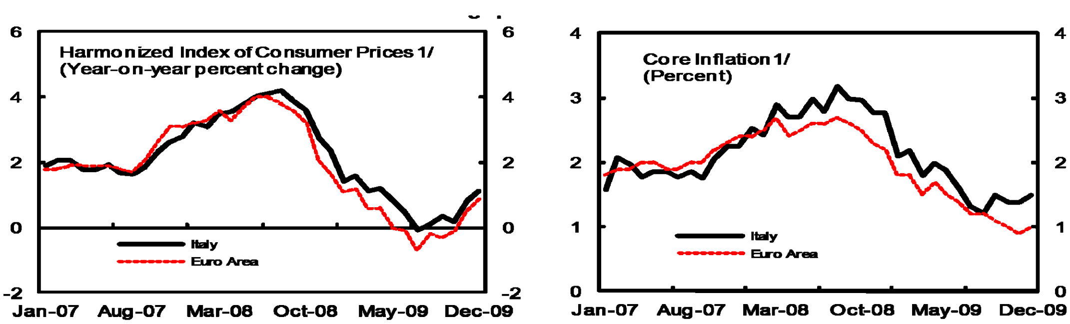
17. **The recovery is expected to be modest**. Staff projects Italy's output to grow by 0.8 percent in 2010 and 1.2 percent in 2011, in line with most other forecasters. The rebound would be driven by the global rebound, resumption of investment, and the restocking cycle, more than offsetting the gradual withdrawal of government support. However, the recovery is likely to be moderate because: (1) the slow rebound of Italy's major trading partners and persistent competitiveness gap will limit the scope for export growth; (2) the sustained rise in non-performing loans, enhanced lending discrimination due to the continued decline in the perceived creditworthiness of borrowers, and the need to rebuild capital in response to forthcoming new regulation are likely to constrain credit supply; (3) rising and persistent unemployment will undermine private consumption; and (4) firms will likely remain cautious on investment due to financing constraints, low capacity utilization, and falling profitability. More generally, the recovery will likely be hampered by many structural factors, including pervasive rigidities in product and labor markets, stagnant productivity, as well as the burden of the public sector.

Italy: Comparative Growth Forecasts

	Forecast Date	2010	2011	2012
IMF/WEO	Apr-10	0.8	1.2	1.5
Ministry of Finance	Jan-10	1.1	2.0	2.0
OECD	Nov-09	1.1	1.5	
European Commission	Oct-09	0.7	1.4	
Consensus	Mar-10	0.8	1.2	

Sources: MEF; OECD; EC; Consensus; and IMF staff estimates.

18. **Inflation is expected to gradually increase in line with the recovery and rising energy prices.** Inflation rose sharply from 0.1 percent year-on-year in August 2009 to



Sources: Istituto Nazionale di Statistica; and Eurostat.
1/ Latest observation is December 2009.

1.1 percent in December. Core inflation reached 1.5 percent year-on-year in December 2009, and the differential with the euro area widened further, largely due to service prices, likely reflecting weak domestic competition. Inflation is projected to rise to 1.4 percent in 2010 and 1.7 percent in 2011 owing to strengthening demand, and rising energy prices.

19. **The competitiveness gap remains significant**. Staff estimates of the equilibrium real exchange rate based on the CGER methodology indicate that there could be a competitiveness gap (real exchange rate overvaluation) of the order of 7–8 percent by 2015. Italy's competiveness has been eroding not just because of low productivity growth, but also because of higher than average inflation compared to the euro area (affecting trade within the euro area) and the strength of the euro (affecting trade with the rest of the world). The former (in particular) will be difficult to reverse, and may weigh on activity for some time, reinforcing the importance of advancing structural measures.

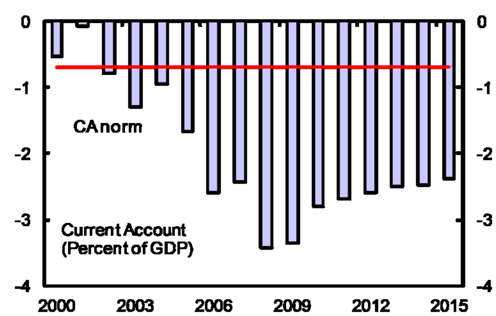
Estimates Applying the CGER Methodology to Italy 1/

	Exchange rate (percent)			Current account (percent of GDP)	
	MB 2/	ERER 3/	ES 4/	2009	2015
Italy	8.1	7.3	6.9	-3.4	-2.4

1/ Positive numbers indicate that REER is above equilibrium.
2/ Macroeconomic balance.
3/ Reduced-form equilibrium real exchange rate.
4/ External stability.

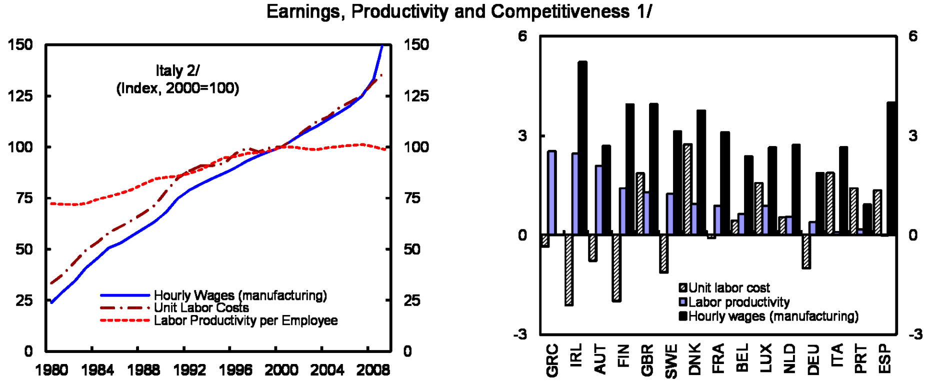
20. **The current account deficit is projected to gradually improve**. The current account has been deteriorating since 2005. It did not improve in 2009, despite a sharp decline of imports, because Italy's export market share continued to shrink. Export growth is expected to pick up in line with the global economy and import growth will likely remain constrained by weak domestic demand. Despite the improvement, overvaluation issues are likely to remain and the current account deficit is expected to remain above the CGER current account norms in the medium-term.

The current account deficit has increased relative to the norm, but is expected to gradually decline over the medium run.



Source: WEO.

Earnings, Productivity and Competitiveness 1/



Sources: Istituto Nazionale di Statistica; European Central Bank;
1/ Cross-country data are average annual growth rates during 1998-2008 for Austria, Greece, Ireland, and Luxemburg. All remaining data are average growth rates during 1998-2009.
2/ Latest observation is as of 2009q4.

A. Fiscal Sector: Deep Expenditure-Based Consolidation Required

Short- and medium-term outlook

27. **The 2010 budget targets a deficit of 5.0 percent of GDP, representing a small reduction with respect to the outturn for 2009.** This targeted improvement in the deficit reflects the phasing out of some 2009 one-off outlays, and implementation of the expenditure rationalization measures. The budget also includes a few stimulus measures equivalent to 0.4 percent of GDP, to be covered mainly by some revenue collection postponed from 2009.

28. **The government plans to reduce the deficit to below 3 percent of GDP by 2012.** The plan, which is outlined in the January 2010 Stability Program Update, envisions a reduction of the deficit below 3 percent of GDP one year earlier than for most of other Excessive Deficit Procedure (EDP)-subject countries (due to its high debt and relatively modest deficit). This will require a fiscal consolidation of over 1 percent of GDP in 2011–12 compared to that based on existing legislation. The authorities have not yet specified the measures through which fiscal consolidation will be achieved.

Italy: Finance Law 2010—Summary of Main Budget Interventions
(Percent of GDP)

	2010	2011	2012
Revenue increasing measures, o/w:	0.29	0.03	0.02
Postponed 2009 income tax installment	0.24		
Revenue reducing measures, o/w:	0.10	0.03	0.03
Aid to auto carriers	0.02		
Extension of tax relief for productivity performance-related pay	0.05	0.02	
Extension of income tax/VAT allowances for building restructuring			0.02
Net revenue measures	0.20	0.00	-0.01
Expenditure increasing measures	0.29	0.07	0.16
Current expenditure, o/w:	0.26	0.06	0.07
Fund for non-self sufficiency and Fund for social policies	0.04		
Increase in National Health Service financing	0.04	0.03	
Extension of *5 per mille* (charitable donation from income tax)	0.03		
Active labor market policies	0.02		
Fund for financing new spending laws	0.05	0.00	0.04
Capital expenditure, o/w:	0.03	0.02	0.09
Tax credit for research	0.01	0.01	
Fund for financing new spending laws			0.03
Infrastructure initiatives (incl. construction in health sector)	0.00	0.00	0.02
Expenditure reducing measures	0.10	0.07	0.17
Current expenditure, o/w:	0.07	0.05	0.17
Trento and Bolzano	0.03	0.03	0.03
Fund for structural economic policy initiatives	0.01		0.12
Capital expenditure, o/w:	0.04	0.02	0.00
Disposal of real estate	0.02	0.02	
FAS (Fund for Underutilized Areas)	0.01	0.00	0.00
Net expenditure measures	0.19	0.00	-0.01
Net fiscal impact (manovra netta)	0.00	0.00	0.00
Gross impact (revenue reducing + expenditure increasing)	0.39	0.10	0.18

Sources: Stability Programme Update, January 2010; and Ministry of Economy and Finance.

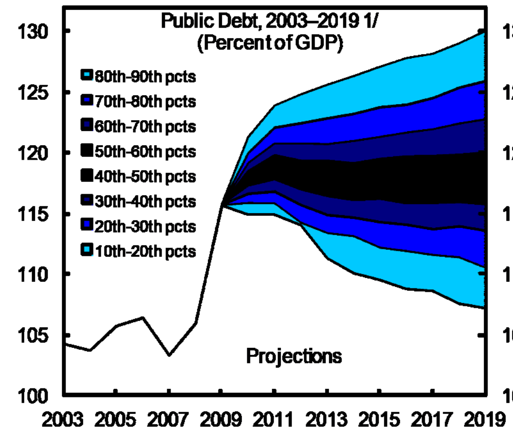
Italy: Comparison of Medium-Term Fiscal Projections, 2008–2012 1/
(Percent of GDP)

	2008	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.
Overall fiscal balance					
Staff	-2.7	-5.3	-5.2	-4.9	-4.9
Authorities					
Unchanged legislation	-2.7	-5.3	-5.0	-4.3	-3.9
Policy scenario	-2.7	-5.3	-5.0	-3.9	-2.7
Primary balance					
Staff	2.5	-0.6	-0.6	0.0	0.4
Authorities					
Unchanged legislation	2.4	-0.5	-0.1	0.9	1.5
Policy scenario	2.4	-0.5	-0.1	1.3	2.7
Overall structural fiscal balance (excluding one-offs) 2/					
Staff	-2.7	-4.1	-3.6	-3.5	-3.9
Authorities					
Unchanged legislation	-3.3	-3.6	-3.1	...	...
Policy scenario	-3.3	-3.6	-3.1	-2.5	-2.0
Public debt					
Staff	106.0	115.8	118.6	120.5	121.6
Authorities					
Unchanged legislation	105.8	115.1	116.9	...	...
Policy scenario	105.8	115.1	116.9	116.5	114.6

Sources: Ministry of Economy and Finance; and IMF staff estimates.
1/ Based on Jan 2010 Stabililty Programme Update, including the impact of the 2010 Finance Law.
2/ One-off measures in 2009, estimated at 0.6 percent of GDP, include mainly receipts of tax amnesty and substitute taxes net of some spending on anti-crisis measures, support to the earthquake zone, and securitization operation. One-offs amount to 0.2 and 0.1percent of GDP in 2008 and 2010, respectively.

29. **The government's fiscal adjustment strategy raises some concerns:**

- **Realism of consolidation plans.** Reducing the deficit to about 2¾ percent of GDP by 2012 would require cuts in primary current spending of 2 percent every year over the period in real terms, even assuming GDP growth of 2 percent in 2011–12. This compares with increases in such spending averaging 2 percent a year over the last decade. Moreover, the plan relies on very optimistic assumptions on spending efficiency, combating tax evasion, unspecified saving in local governments deriving from fiscal federalism, and one-off measures.



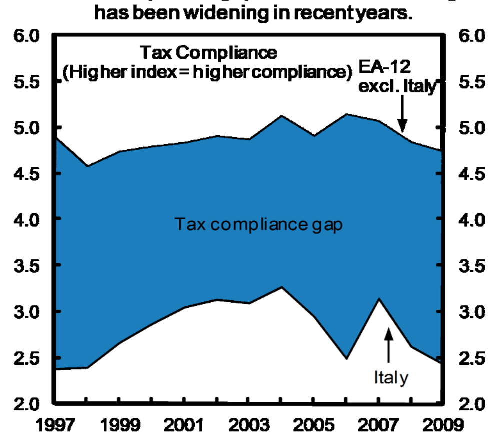
Source: IMF staff calculations.
1/ Assumes primary balance path in 2010–12 in line with the authorities' policy scenario (Stability Programme Update, Jan 2010; and Nota di Aggiornamento 2010–12); primary balance is assumed to stay constant after 2013.

- **The planned consolidation is not ambitious enough.** Meeting the minimum requirement under the Stability and Growth Pact (an annual structural adjustment, net of one-offs, of ½ percent of GDP) in 2010–12, would still not deliver the medium-term objective (MTO) of structural balance by the end of the period. Moreover, debt service costs rise continuously, and the debt ratio would likely remain well above 100 percent of GDP a decade from now, with potentially further negative implications on growth.

- **Withdrawal of stimulus.** The plan assumes that the existing anti-crisis measures will largely expire by 2012. However, as unemployment rate is still rising and will persist a while, there may continue to be a need for income and employment support.

- **Weaknesses in the budget process.** Plans to have a more streamlined and targeted budget have proven difficult to implement, with amendments and new extensions of existing provisions having quickly followed the just-approved budget.

The tax compliance gap with euro area average has been widening in recent years.



Source: World Competitiveness Online.

- **Tax amnesty.** The recent tax amnesty, despite its announced success in terms of volumes of repatriated capital, could decrease already low tax compliance while the impact of accompanying measures to deter future tax evasion is yet to be seen. Unlike recent initiatives in other countries that focused on disclosure, Italy's amnesty provides full anonymity to the taxpayer, immunity against further administrative or criminal investigations, and allows the regularization of funds held abroad in connection with tax evasion in return for paying a relatively low final tax.

30. **The staff's medium-term scenario is less optimistic than the authorities' (Figure 4).** The overall deficit in 2010 is projected to remain at about the same level as in 2009, and only slowly declines in following years. Less sanguine assumptions about expenditure savings (especially on current spending), together with different macroeconomic assumptions after 2010, explain most of the difference. While the structural primary balance would stabilize at about 1¼ percent of GDP over the medium term, rising interest and pension cost will make structural consolidation difficult, and the debt ratio could increase to about 125 percent of GDP by the end of the projection period.

Longer-term outlook

33. **Official longer-term fiscal projections seem relatively favorable compared to those of euro area peers.** Although Italy had the highest pre-crisis debt ratio in the euro area, it is projected to have the lowest debt ratio in the euro area in 2060 (206 percent of GDP versus an average of 422 percent of GDP), according to the 2009 Sustainability Report of the European Commission (EC). Similarly, various long-term fiscal sustainability analyses place Italy among the countries with the lowest sustainability gap. This positive outlook is largely due to the projected stabilization of pension spending despite the rapidly aging population, as a result of a series of past pension reforms with future implications. Pension spending, however, will still remain among the highest in the world.

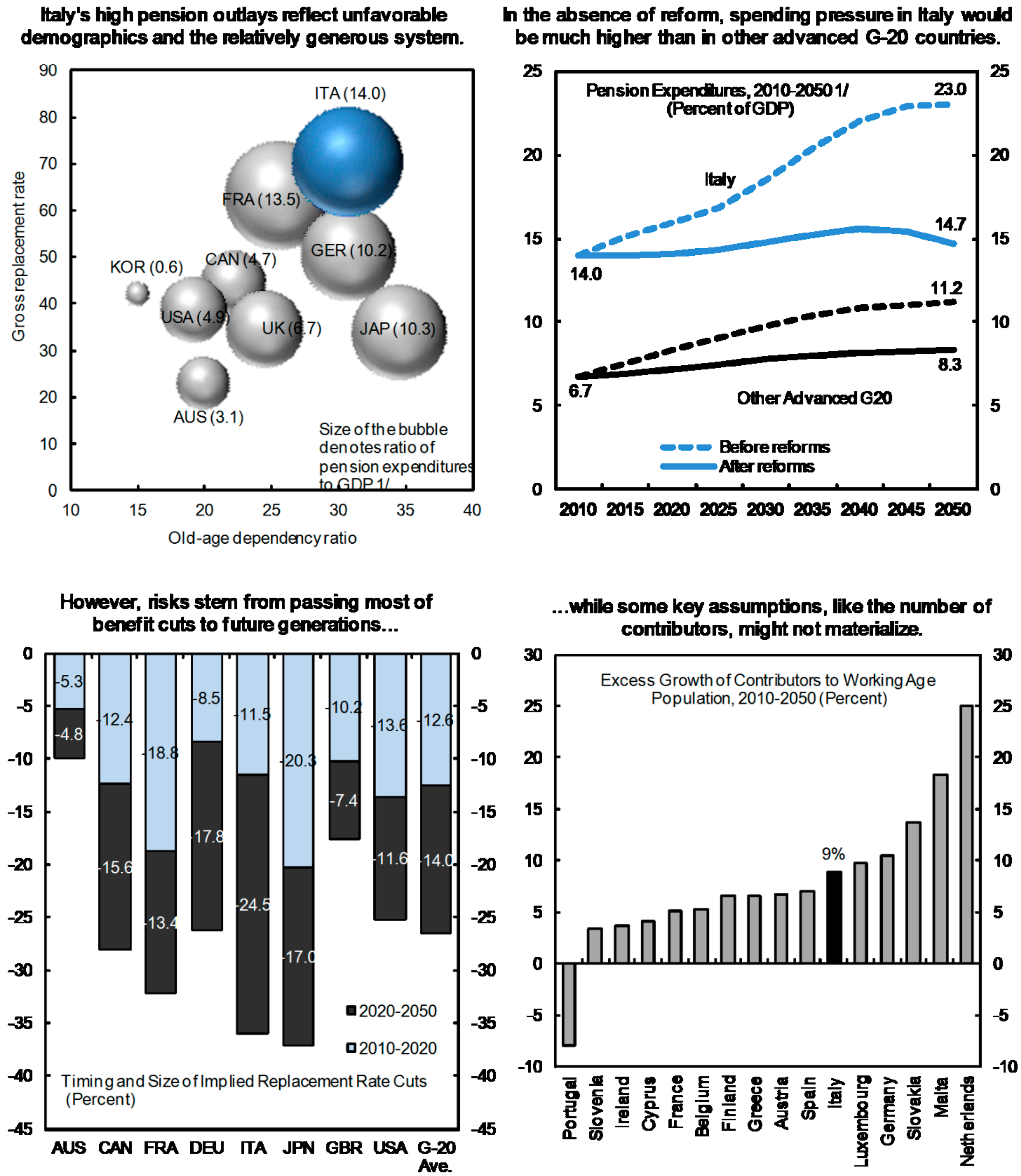
Ageing Related Government Expenditure, 2007–2060
(Percentage points of GDP)

	Pensions		Health care		Long-term care		Unemployment benefits		Education		Total	
	Level 2007	Change 2007 2060	Level 2007	Change 2007 2060	Level 2007	Change 2007 2060	Level 2007	Change 2007 2060	Level 2007	Change 2007 2060	Level 2007	Change 2007 2060
Germany	10.4	2.3	7.4	1.8	0.9	1.4	0.9	-0.3	3.9	-0.4	23.6	4.8
Spain	8.4	6.7	5.5	1.6	0.5	0.9	1.3	-0.4	3.5	0.1	19.3	9.0
France	13.0	1.0	8.1	1.2	1.4	0.8	1.2	-0.3	4.7	0.0	28.4	2.7
Italy	**14.0**	**-0.4**	**5.9**	**1.1**	**1.7**	**1.3**	**0.4**	**0.0**	**4.1**	**-0.3**	**26.0**	**1.6**
Portugal	11.4	2.1	7.2	1.9	0.1	0.1	1.2	-0.4	4.6	-0.3	24.5	3.4
EU27	10.2	2.4	6.7	1.5	1.2	1.1	0.8	-0.2	4.3	-0.2	23.1	4.7
EA12	11.1	2.8	6.7	1.4	1.3	1.4	1.0	-0.2	4.2	-0.2	24.4	5.2

Source: European Commission.

34. **These results, however, hinge on a number of optimistic assumptions.** The projections, while based on the commonly applied EC assumptions, assume a long-term average labor productivity growth of over 1.6 percent, well above the stagnant growth rate experienced in the past decade. They are also based on the key assumption that the pension reform would be fully implemented, including periodic revisions of the conversion coefficients and the maintenance of the contributory principle. Moreover, the remaining reform is heavily back-loaded, with about two thirds of the adjustments in benefits expected to take place after 2020 compared to only about half of the adjustment after 2020 for reforms in other advanced economies. The sharp fall in the replacement ratio, from 67 percent in 2007 to 49 percent in 2060, could be politically challenging. Further risks would likely arise from the growing use of flexible labor market arrangements which reduce the pension revenues and result in lower pension benefits.

Figure 5. Italy: Pension System, Reforms, and Risks



Sources: Country authorities; European Commission; OECD; and IMF staff estimates.

1/ Estimates are based on the 2009 Ageing Report and do not reflect subsequent official revisions.

Box 1. Recent Fiscal Framework Reforms

Budget reform. The 2009 Accounting and Public Finance law (*Legge di contabilità e finanza pubblica*) marks a first step in bringing Italy's public financial management in line with best international practices. Its focus on harmonizing accounting systems, strengthening expenditure control and monitoring, and enhancing performance orientation of the budget is welcome. But the reform falls short on resolving some key issues such the establishment of a strict top-down budgeting process, the adoption of binding medium-term expenditure ceilings, the use of a credible current-policy baseline, the introduction of long-term scenarios, the (further) enhancement of transparency, and the strengthening of independent scrutiny of forecasts and policies. The law also envisages a move, over three years, toward a cash concept in budgeting (though informed by accrual-based accounting) but its pilot-based implementation implies uncertainties as to the outcome of this proposal.

Fiscal federalism. In May 2009, the Parliament adopted a Delegation Law outlining the main principles of fiscal federalism. The law stipulates that fiscal federalism must be consistent with Italy's commitments under the Stability and Growth Pact and gives the government the authority to issue main implementation decrees by May 2011. In addition, it states the general principle that standard costs, fiscal discipline, and accounting uniformity will be important features. The key principles of harmonization of public sector budgets are expected to be defined by mid-May 2010 but the work of the technical commission is still lagging, and only a decree on transferring public property to local authorities (*federalismo demaniale*) has been introduced. The bulk of reform implementation measures, including determination of standard costs, subnational revenue assignments, and the size and sharing of the equalization fund will be adopted by May 2011.

B. Financial Sector: Mitigating Vulnerabilities

41. **Going forward, Italian banks will benefit from improved macroeconomic conditions, but vulnerabilities will remain.** In line with the projected output recovery, revenues are expected to increase moderately, due to a low rate of lending growth, a limited rise in interest rates, and some positive contribution from commission income. A more favorable environment for corporates and households is expected to slow the pace of deterioration in credit quality. However, given the still fragile economy, and the lag between economic recovery and improvement in asset quality, banks will continue to face a high level of credit risk for the next two years. For the two largest banks, further deterioration of credit risk in central and Eastern Europe could add to earnings pressure.

Box 2. Scenario Analysis of the Banking Sector

According to a scenario analysis run by staff, the five largest banks would not be able to generate sufficient profits to significantly strengthen capital ratios. The Base Scenario takes into consideration a macroeconomic outlook in line with IMF estimates of a 2010 GDP growth of 0.8 percent, and 1.2 percent in 2011. As a result, loans are expected to grow by 1–3 percent in 2010–11, revenues by 1–3 percent, loan loss provisions to further increase by 6-9 percent in 2010, before falling by 3–0 percent in 2011. Under such assumptions, cumulated loan loss provisions in the 2010–2011 periods would be one third higher than in the 2008–2009 periods. Earnings would slightly improve in 2010 and in 2011, but would continue to remain significantly lower than before the crisis. Assuming a dividend distribution of the order of 10-30 percent of earnings, aggregated Core Tier1 ratio would rise in the 2010–11 period by less than 0.5 percentage points by 2011. The capital shortfall with respect to an 8 percentage Core Tier1 level would on average progressively close by 2011, although with significant bank by bank convergence differences.

In a more severe scenario with a more sluggish economic recovery and a weaker corporate landscape, earnings would shrink further and capital ratios would deteriorate. The Severe Scenario takes into consideration a harsh macroeconomic outlook, with GDP declining by -1.7 percent in 2010 and by -1.3 percent in 2011 (or a cumulative 2.5 percentage points lower than in the Base Scenario). Under this scenario, loans would remain flat, revenue growth would be negative, and loan loss provisions could increase by some 18-22 percent, in both 2010 and 2011. The cumulated loan losses would be 65 percent higher than in 2008-09. Such scenario would generate a significant erosion of profitability. On an aggregated level, the Core Tier1 ratio would deteriorate to below the 7 percent mark, for several banks.

42. **Efforts to strengthen banks' recapitalization should thus continue.** Banks, which will already have a hard time raising capital under existing guidelines (see Box 2), will also need to comply with a new regulatory framework that will call for more and higher quality capital. The impact of the new capital rules on Italian banks should be manageable, given the stringent requirements already applied by the Bank of Italy with regard to capital deductions and to hybrid capital limits. However, given the still moderate outlook for profitability, it will be difficult to significantly reinforce capital through earnings retention, even assuming low dividend distributions. Banks should thus be encouraged, on a case by case basis, to continue to dispose of non strategic assets and raise capital from the market, as market conditions improve. In particular, banks that took advantage of the recapitalization bonds will need to prepare an alternative recapitalization strategy as the interest rate on these securities rises sharply in three years.

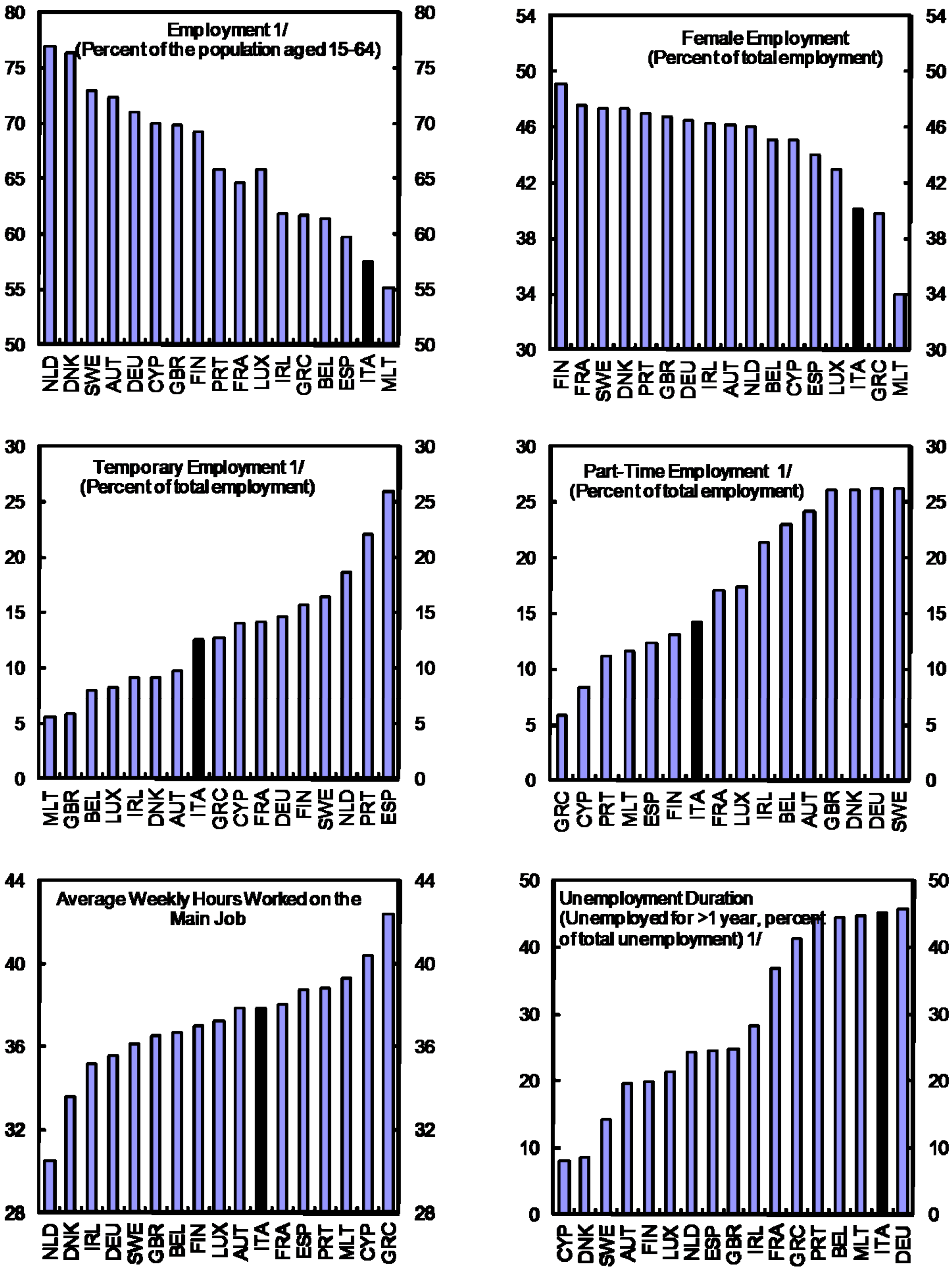
43. **The authorities should guide the domestic banking system towards the prompt adoption of the latest recommendations of the Basel Committee on Banking Supervision.** Although implementation of the proposals will take time, Italian banks should begin to adapt their capital strategies around the new regulatory framework, and the authorities should quickly adopt the new international rules, as soon as possible after they are defined.

than one year, substantially above the euro area average. While the deregulation of fixed-and part-term contracts in recent years has improved labor market flexibility, it has also resulted in more "atypical" employment, contributed to stagnant labor productivity, and exposed workers to increased employment risk without commensurate improvements in the social safety net.

52. **A second generation of labor market reforms is needed.** Italy's social safety net is generous for some worker groups, but virtually nonexistent for (most) others; the extent of employment protection varies substantially across worker groups; and the aggregate wage distribution is highly compressed. The existing wage bargaining system exacerbates these disparities: nationally bargained wages are less binding in the North, but too high for South, and the lack of a broad social safety net, particularly for those in the South**,** prevents sufficient spatial mobility. The public sector should take the lead in decentralizing wage bargaining arrangements, taking into account regional differences in productivity and cost of living. In this respect, a program to enhance transparency and productivity-related rewards in the public administration has been introduced, although significant effects on wage negotiations to be seen.

53. **The authorities pointed out that many reforms especially in the labor market had already taken place, though with unequal effects across the country.** At the same time, the authorities saw the next three year—during which no elections are scheduled—as a golden opportunity to proceed with growth-enhancing reforms. The authorities indicated that government would announce decisive reforms in the next few months, especially in the area of fiscal federalism and tax policy.

Figure 6. Italy's Labor Market Outcomes in Cross-Country Comparison, 2009



Source: Eurostat.
1/ All data are as of 2009q3.

64. **It is proposed that the next Article IV Consultation be held on the regular 12-month cycle.**

Table 1. Summary of Economic Indicators
(Annual percentage change, unless noted otherwise)

	2007	2008	2009 1/	2010 1/	2011 1/	2012 1/	2013 1/	2014 1/	2015 1/
Real GDP	1.5	-1.3	-5.0	0.8	1.2	1.5	1.4	1.3	1.3
Public consumption	0.9	0.8	0.6	0.2	0.0	0.8	0.6	0.6	0.6
Private consumption	1.1	-0.8	-1.8	0.9	1.2	1.7	1.6	1.3	1.1
Gross fixed capital formation	1.7	-4.0	-12.1	1.7	2.4	2.8	2.3	2.0	2.0
Final domestic demand	1.2	-1.2	-3.5	0.9	1.2	1.7	1.5	1.3	1.2
Stock building 2/	0.1	-0.3	-0.3	0.5	0.0	0.0	0.0	0.0	0.0
Net exports 2/	0.2	0.1	-1.3	-0.1	-0.1	-0.2	-0.1	0.0	0.0
Exports of G&S	4.6	-3.9	-19.1	2.8	3.5	3.8	4.1	4.1	4.1
Imports of G&S	3.8	-4.3	-14.5	3.0	3.6	4.2	4.0	3.8	3.6
Money and credit (end of period, percent change)									
Private sector credit 3/	9.8	4.9	1.7	...	...	...	...	...	...
National contribution to euro area M3 4/	7.6	6.9	5.8	...	...	...	...	...	...
Interest rates (in percent, end of period)									
6-month interbank rate	4.9	3.7	1.0	...	...	...	...	...	...
Government bond rate, 10-year	4.7	4.5	4.1	...	...	...	...	...	...
Resource utilization									
Potential GDP	0.8	0.7	-1.9	0.5	0.6	0.6	0.7	0.7	0.7
Output Gap (% of potential)	1.5	-0.5	-3.7	-3.3	-2.8	-1.9	-1.1	-0.6	0.0
Natural rate of unemployment	6.3	6.7	7.5	8.4	8.4	8.2	7.8	7.6	7.4
Employment	1.0	0.8	-1.5	-0.7	0.4	0.7	0.9	0.9	0.8
Unemployment rate (%)	6.2	6.8	7.8	8.7	8.6	8.3	7.9	7.6	7.4
Prices									
GDP deflator	2.6	2.8	2.1	1.4	1.7	1.8	1.8	1.9	2.0
Consumer prices	2.0	3.5	0.8	1.4	1.7	1.8	1.8	1.9	2.0
Hourly compensation	2.9	4.1	2.3	2.0	2.1	2.4	2.5	2.8	2.9
Productivity	0.4	-1.0	-2.4	0.2	0.4	0.5	0.6	0.7	0.8
Unit labor costs	2.5	5.1	4.7	1.8	1.7	1.9	1.9	2.1	2.1
Fiscal indicators									
General government net lending/borrowing 5/	-1.5	-2.7	-5.3	-5.2	-4.9	-4.9	-4.8	-4.7	-4.6
Structural balance net of one-offs (in % of potential GDP)	-2.5	-2.6	-3.9	-3.5	-3.4	-3.8	-4.2	-4.5	-4.6
Public debt 5/	103.4	106.0	115.8	118.6	120.5	121.6	122.8	123.9	124.7
Exchange rate regime				Member of EMU					
Exchange rate (NC/US$)	1.4	1.5	1.4	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	102.0	104.4	104.5	...	...	...	...	...	...
Real effective exchange rate based on									
CPI (2000=100)	113.2	115.0	115.8	...	...	...	...	...	...
normalized ULC (2000=100)	135.7	145.2	156.0	...	...	...	...	...	...
External sector 5/									
Current account balance	-2.4	-3.4	-3.4	-2.8	-2.7	-2.6	-2.5	-2.5	-2.4
Trade balance	0.2	0.0	0.0	0.3	0.4	0.3	0.2	0.2	0.2
Saving investment balance 5/									
Gross national saving	19.4	17.7	15.5	16.1	16.2	16.5	16.8	16.9	17.2
Public	2.3	0.8	-2.1	-1.8	-1.9	-1.8	-2.0	-1.9	-1.8
Private	17.2	16.9	17.6	17.9	18.1	18.3	18.7	18.8	19.0
Gross domestic investment	21.9	21.1	18.9	18.9	18.9	19.1	19.3	19.4	19.6
Gross fixed domestic investment	21.2	20.7	18.9	19.2	19.5	19.9	20.2	20.4	20.6
Public	2.3	2.2	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Private	18.9	18.5	16.5	16.7	17.1	17.5	17.8	18.0	18.2
Net lending	-2.4	-3.4	-3.4	-2.8	-2.7	-2.6	-2.5	-2.5	-2.4

Sources: National Authorities; Eurostat; and IMF staff calculations (April 2010 WEO).
1/ Staff estimates and projections, unless otherwise noted.
2/ Contribution to growth.
3/ Twelve-month credit growth, adjusted for securitizations.
4/ Excludes currency in circulation held by nonbank private sector.
5/ Percent of GDP.

Table 2. Italy: General Government Accounts, 2007–2015
(Percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010		2011			2012			2013	2014	2015
			Prel.	Proj.	SP-T/P	Proj.	SP-T	SP-P	Proj.	SP-T	SP-P	Proj.	Proj.	Proj.
Total Revenues	46.9	46.7	47.2	46.6	46.5	46.3	46.1	…	46.3	46.1	…	46.1	46.1	46.1
Current revenues	46.6	46.5	46.2	46.2	46.1	45.9	45.7	…	45.9	45.7	…	45.7	45.7	45.7
Tax revenues	29.8	29.1	29.1	28.6	28.7	28.4	28.3	…	28.4	28.4	…	28.4	28.4	28.4
Direct taxes	15.1	15.3	14.6	14.9	15.3	14.9	15.1	…	15.1	15.4	…	15.1	15.1	15.1
Indirect taxes	14.7	13.8	13.6	13.6	13.4	13.5	13.2	…	13.3	13.0	…	13.2	13.2	13.2
Social security contributions	13.3	13.8	14.1	14.0	13.8	14.0	13.8	…	13.9	13.7	…	13.8	13.8	13.8
Other current revenues	3.5	3.6	3.8	3.7	3.7	3.6	3.6	…	3.6	3.6	…	3.5	3.5	3.5
Capital revenues	0.3	0.2	1.1	0.4	0.4	0.4	0.4	…	0.4	0.4	…	0.4	0.4	0.4
Total expenditures	48.4	49.4	52.5	51.8	51.4	51.3	50.4	…	51.2	50.0	…	50.9	50.8	50.7
Current expenditures	44.3	45.7	48.2	48.0	47.5	47.8	46.9	…	47.7	46.5	…	47.6	47.6	47.4
Wages and salaries	10.6	10.8	11.3	11.3	11.2	11.0	10.9	…	10.7	10.6	…	10.7	10.6	10.6
Goods and services	7.9	8.2	9.0	8.9	8.5	8.8	8.3	…	8.7	8.2	…	8.4	8.3	8.1
Social transfers	17.1	17.7	19.2	19.2	18.9	19.1	18.8	…	19.1	18.6	…	19.2	19.2	19.2
Other	3.7	3.8	4.1	4.0	4.0	4.0	3.7	…	3.9	3.6	…	3.8	3.7	3.6
Interest payments	5.0	5.2	4.7	4.6	4.9	4.9	5.2	5.2	5.3	5.5	5.4	5.5	5.8	5.9
Capital expenditures	4.0	3.7	4.3	3.8	3.9	3.5	3.5	…	3.5	3.6	…	3.3	3.3	3.3
o/w: Asset sales	-0.1	-0.1	-0.1	-0.1	…	-0.1	…	…	-0.1	…	…	-0.1	-0.1	-0.1
Overall balance	-1.5	-2.7	-5.3	-5.2	-5.0	-4.9	-4.3	-3.9	-4.9	-3.9	-2.7	-4.8	-4.7	-4.6
Memorandum items:														
Primary balance	3.5	2.5	-0.6	-0.6	-0.1	0.0	0.9	1.3	0.4	1.5	2.7	0.7	1.0	1.3
One-off measures (negative=balance-improving)	-0.2	-0.2	-0.6	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1
Cyclically-adjusted overall balance	-2.3	-2.5	-3.4	-3.5	-3.0	-3.5	…	-2.6	-3.9	…	-2.0	-4.2	-4.5	-4.6
Structural overall balance excl. asset sales	-2.4	-2.5	-3.5	-3.6	…	-3.6	…	…	-4.0	…	…	-4.3	-4.5	-4.6
Struct. overall balance excl. asset sales 1/	-2.4	-2.5	-3.4	-3.5	…	-3.5	…	…	-3.9	…	…	-4.2	-4.5	-4.6
Struct. primary balance excl. asset sales 1/	2.7	2.6	1.1	1.0	…	1.2	…	…	1.3	…	…	1.2	1.2	1.2
Structural overall balance excl. one-offs	-2.4	-2.7	-4.1	-3.6	-3.1	-3.5	…	-2.5	-3.9	…	-2.0	-4.3	-4.5	-4.6
Struct. overall balance excl. one-offs 1/	-2.5	-2.6	-3.9	-3.5	…	-3.4	…	…	-3.8	…	…	-4.2	-4.5	-4.6
Struct. primary balance excl. one-offs 1/	2.6	2.5	0.6	1.0	…	1.4	…	…	1.3	…	…	1.2	1.2	1.2
Primary current expenditure real growth rate 2/	1.4	0.9	3.4	0.5	0.3	0.1	-0.6	…	0.4	0.2	…	0.6	0.6	0.6
Nominal GDP growth rate 2/	4.1	1.4	-3.0	2.2	2.6	2.9	3.8	…	3.4	3.9	…	3.3	3.2	3.3
Real GDP growth rate 2/	1.5	-1.3	-5.0	0.8	1.1	1.2	2.0	2.0	1.5	2.0	2.0	1.4	1.3	1.3
Output gap 1/	1.5	-0.5	-3.7	-3.3	-4.0	-2.8	…	-2.7	-1.9	…	-1.5	-1.1	-0.6	0.0
Public debt	103.4	106.0	115.8	118.6	116.9	120.5	…	116.5	121.6	…	114.6	122.8	123.9	124.7

Sources: ISTAT; Ministry of Economy and Finance; and IMF staff estimates (April 2010 WEO).
1/ Percent of potential GDP.
2/ Percent.
SP-T = Stability Programme Update (unchanged legislation scenario), January 2010
SP-P = Stability Programme Update (policy scenario), January 2010

Table 3. Italy: Financial Soundness Indicators
(Percent, unless otherwise noted)

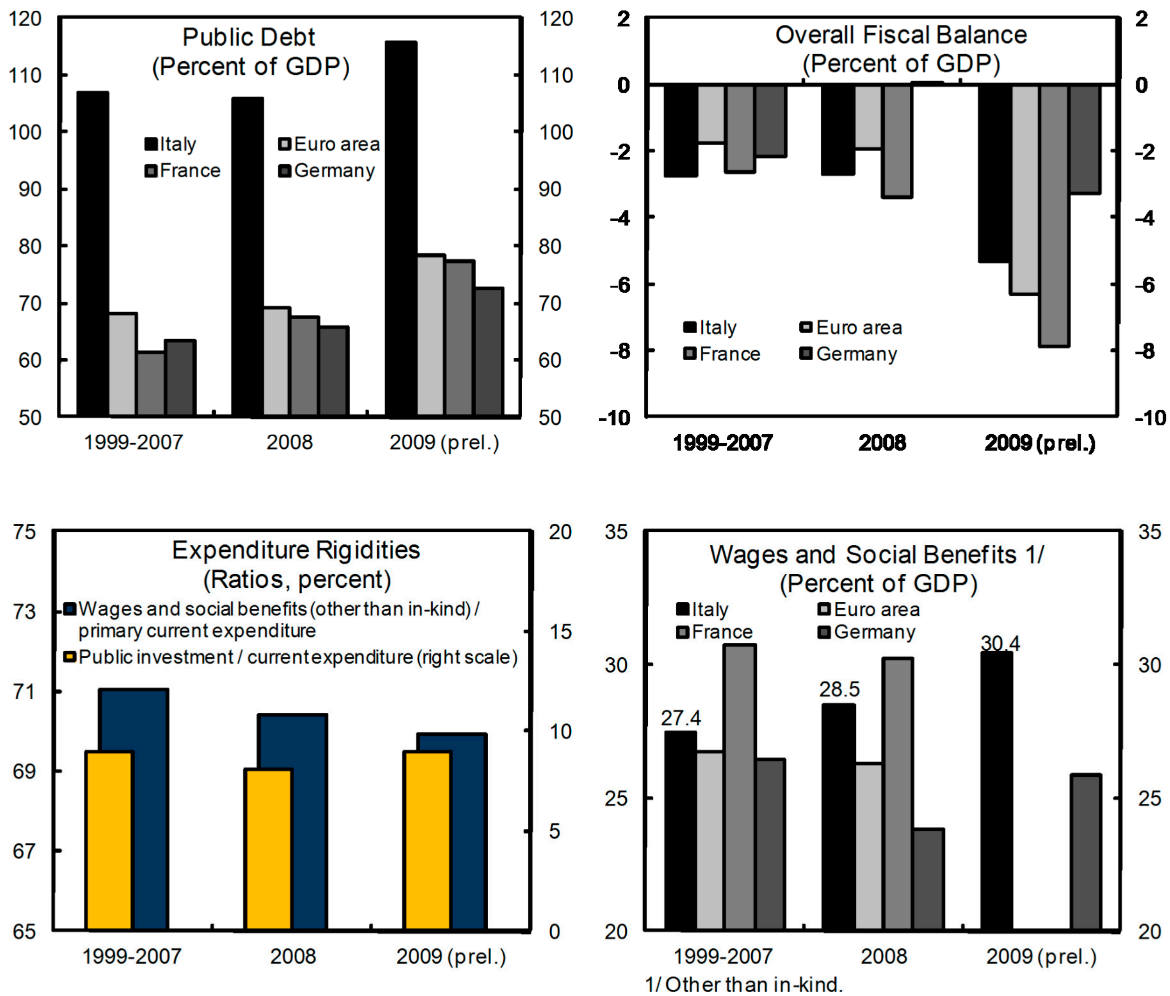
	2002	2003	2004	2005	2006	2007	2008	2009	Latest available
Core set									
Deposit-taking institutions									
Capital adequacy									
Regulatory capital to risk-weighted assets	11.2	11.4	11.6	10.6	10.7	10.4	10.8	11.3	June
Regulatory tier I capital to risk-weighted assets	8.2	8.5	8.8	8.1	7.8	7.7	7.6	8.2	June
Asset quality									
Nonperforming loans 1/									
Share of total gross loans	6.5	6.7	6.6	5.3	4.9	4.6	4.9	6.6	Sept.
Percentage change	2.4	7.6	4.7	-12.4	1.6	2.3	11.3	35.7	Sept.
Sectoral distribution of loans to total loans									
General government	5.3	4.7	4.5	4.5	4.5	3.9	3.7	3.9	Sept.
Financial corporations	14.6	13.8	12.1	11.7	11.5	11.2	11.2	10.4	Sept.
Nonfinancial corporations and sole proprietorships	59.0	59.6	59.5	58.8	58.5	59.9	60.9	60.5	Sept.
Building and construction	6.2	6.5	6.7	6.9	6.9	7.4	7.6	7.8	Sept.
Consumer households	21.0	21.9	23.9	25.0	25.5	25.0	24.2	25.3	Sept.
Earnings and profitability									
Return on assets	0.5	0.5	0.6	0.7	0.8	0.7	0.3		
Return on equity	7.1	7.4	9.3	9.7	14.3	12.9	4.8		
Interest margin to gross income	56.6	55.4	55.9	54.5	51.9	56.6	66.4		
Non-interest expenses to gross income	59.8	61.0	60.6	59.8	59.4	59.8	66.5		
Liquidity									
Liquid assets to total assets (liquid asset ratio)	7.8	8.6	8.3	7.5	6.5	4.1	4.0	5.1	Sept.
Leverage 2/ 3/	20.2	20.8	20.7	19.2	19.7	21.1	23.9	24.4	June
Encouraged set									
Deposit-taking institutions									
Capital to assets 3/	6.7	6.4	6.4	6.9	4.9	6.4	6.6	8.0	Sept.
Average risk weight (ratio of risk-weighted assets to assets) 3/	0.6	0.6	0.6	0.6	0.7	0.7	0.6	0.5	June
Geographical distribution of loans									
North	62.2	62.3	62.2	62.0	61.8	61.9	59.9	61.7	Sept.
Center	24.1	24.0	23.5	23.5	23.4	23.3	23.3	23.2	Sept.
South	13.6	13.7	14.3	14.6	14.7	14.8	14.3	15.1	Sept.

Sources: Bank of Italy and IMF staff calculations.
1/ Bad debts plus substandard loans.
2/ Assets on Tier 1 capital.
3/ Not in percent.

II. Current Fiscal Environment and Pension Reforms

A. The State of Public Finances in Italy

The financial crisis worsened Italy's already fragile fiscal position and exacerbated the structural weaknesses of the budget. Public debt reached 115.8 percent of GDP in 2009—second only to Japan among advanced G-20 countries. The deficit doubled, despite modest stimulus measures and large one-off revenue receipts. Recent efforts to introduce more flexibility in the budget have helped ease slightly expenditure rigidities but the share of non-discretionary primary spending in GDP increased substantially, reaching 30½ percent of GDP in 2009.[4] The high tax burden, including relatively high taxes on wages, and persistent problems with improving significantly the revenue-raising potential further constrain the fiscal policy space.



Sources: WEO; and Eurostat.

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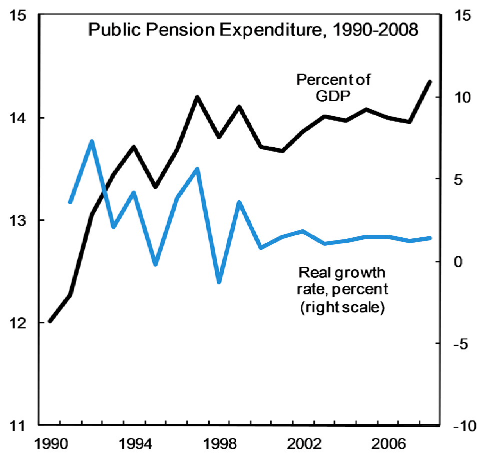
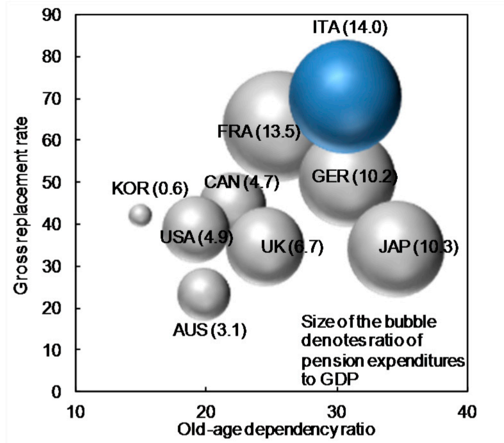
[4] Including in-kind social benefits increases non-discretionary spending to 33½ percent of GDP.

Pension expenditure is relatively large but its growth rate has stabilized since 2000.[5] With one-third of budgetary resources spent on pensions, Italy has the largest share of pension expenditure in GDP among advanced economies. In addition to demographic factors—one inactive person over 65 for every two employed 15–64—the high level of pension spending reflects the relative generosity of the system. After several reforms, however, the growth rate of real pension spending has stabilized at below 1½ percent per year.



Source: ISTAT.

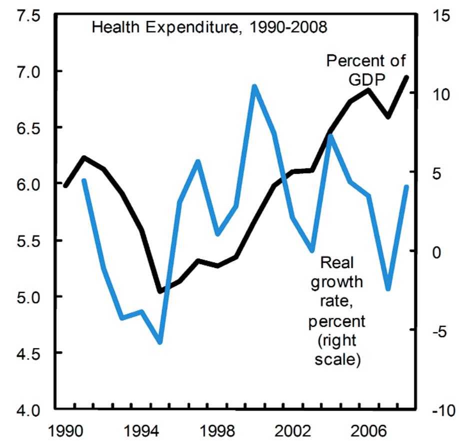


Sources: Country authorities; European Commission; OECD (2009); and IMF staff estimates.

Other age-related expenditures, especially health spending, have been on the rise and also show greater volatility. At about 7 percent of GDP, the level of public health spending is near the euro area average. The decentralized nature of health services involves risks, especially in the presence of "soft" budget constraints and negotiations of the health budget (*Patto per la salute*) between the central and subnational governments (the latter provide about 1/3 of total contributions to the health system).[6] Ongoing fiscal federalism reform compounds the uncertainty in this area.

[5] RGS (2009, 2010) lists several different definitions of pension expenditure depending on the specific social benefit programs included in the calculation. In this annex, the MEF/RGS definition is used, as in the general government fiscal accounts. MEF/RGS definition includes old-age, disability, and survivors (IVS) pensions and old-age means tested transfers (social pensions and social allowances starting from 1995). This definition excludes severance payments (TFR) by private and public employers (estimated at over 1¼ percent of GDP).

[6] The financial position of the National Health Service (*Servizio Sanitario Nazionale, SSN*) has however improved somewhat in recent years, with the deficit of €3.2 billion (0.2 percent of GDP) in 2008 expected to have been covered by the regions.



Source: ISTAT.

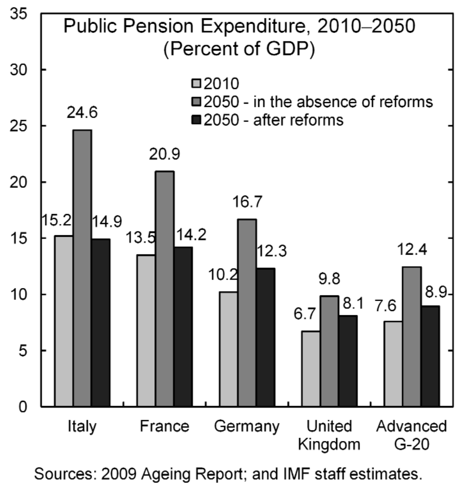
B. Pension reforms in Italy

In many ways, the structure of the Italian pension system is broadly in line with pension systems in other advanced G-20 countries. These systems generally offer a means-tested pension benefit as the basic layer of retirement income accompanied by an earnings-related mandatory component and voluntary occupational schemes (Appendix Table A2). Nearly all of these systems index pensions to prices. Although Italy uses Notional Defined Contribution Accounts—which directly link contributions to benefits— instead of the traditional Defined Benefit structure of public pensions in all other advanced G-20, all these systems generally use current workers' contributions to pay for current pensions.

In Italy, however, public pensions play a larger role than in other advanced G-20 countries. The Italian system offers the highest average gross replacement rate (nearly 70 percent of average earnings) and has a relatively high payroll tax rate among the advanced G-20. Even accounting for the already legislated reforms, Italy will still have the highest replacement rate among these countries for many decades—only after 2055 France would have a slightly higher replacement rate.

	Social Security Contributions 2010 1/	Total tax wedge 1/	Replacement rates 2/		
			2010	2030	2060
Australia	5.7	26.9	23	23	23
Canada	16.8	31.3	45	…	…
France	39.4	49.3	63	53	48
Germany	33.4	52.0	50	46	43
Italy	31.5	46.5	71	64	47
Japan	22.4	29.5	41	34	…
Korea, South	15.8	20.3	58	46	…
United Kingdom	18.0	32.8	35	35	37
United States	14.3	30.1	39	35	35

Sources: OECD (2009); and IMF staff estimates.
1/ In percent of labor cost.
2/ In percent of average wages.



In the absence of the envisaged adjustments, demographic pressures would increase outlays substantially. In Italy, pension spending would increase from 15¼ percent of GDP in 2010 to 24½ percent in 2050. Other advanced G-20 countries face much less pressing fiscal demands due to demographics, in large part because of their smaller current pension expenditures.

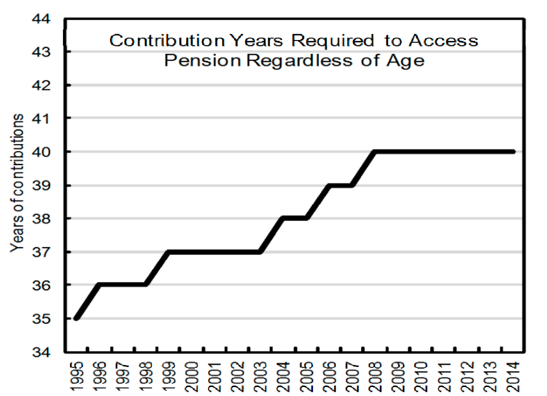
The Italian pension reform was a crucial response to these enormous demographic challenges. The waves of reforms in 1990s and 2000s included a combination of measures to increase revenues and reduce the generosity of benefits, including via increasing the age prerequisites to access pension (see Box 1). As a result, the authorities' latest estimates suggest that pension spending would decline from the 2008 level of 14¼ percent of GDP to about 13½ percent of GDP in 2060. Other advanced G-20 countries have also adopted reforms to offset the changes in demographics.

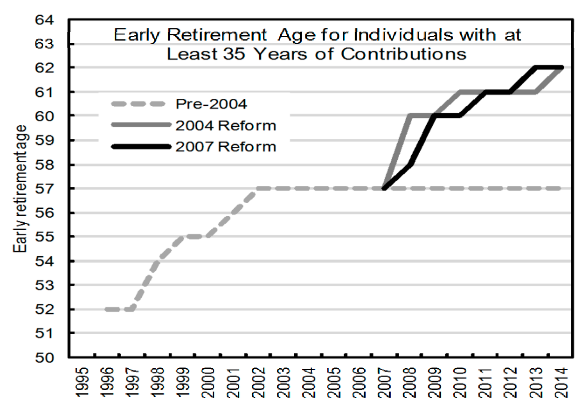
The reform path has not been without setbacks. Over the years, discretionary adjustments to the system have been introduced, some of which delayed or reversed the reform impact. These included a five year delay (from 2005 to 2010) in reviewing the transformation coefficients—an important component of the system that reduces benefits to reflect increases in longevity. Also, increases in the early retirement age were partially delayed (and even slightly lowered for those with 36 years of contributions). As a result of incremental changes, the system continues to be very complex.

Despite these setbacks, the impetus for reform continues. The 2004 reform widened the "exit windows" for claiming early retirement, effectively increasing the early retirement age by up to 9–12 months. The 2007 reform responded to the delay in transformation coefficients by increasing the frequency (from every 10 to every 3 years) of the adjustments and making them administrative (the hearing of parliamentary committees, employers' federation and trade unions is no longer required). It also set a more rapid increase of the early retirement age to 62 in 2013 instead of 2014, while a 2009 law linked the early retirement age to increases in life expectancy starting in 2015.

Box 1. Highlights of the Italian Pension Reform

The 1992 reform cut net pension liabilities by about 25 percent. The main changes included: increasing the retirement age from 60 (55) to 65 (60) for men (women); increasing reference earnings from 5 to 10 years (lifetime earnings for younger workers); changing valorization to prices plus 1 percent; increasing contributing years from 15 to 20; and, most importantly, modifying indexation from wages to prices. **The 1995 reform adopted a Notional Defined Contribution system** in which pension benefits depend on lifetime contributions and GDP growth. The retirement age was set at 57 (with 5 years of contributions), with benefits adjusted depending on the age at which pensions are first claimed. After first receipt, pensions grow with inflation. **The 2004 reform raised the minimum retirement age** from 57 to 60 in 2008 to 62 in 2014 for those with a minimum of 35 years of contributions, along with widening the "exit windows". **The 2007 reform smoothed the initial increase in the retirement age (from 57 to 58 in 2008) but brought forward the increase to age 62 to 2013 (63 for the self-employed).** Additionally, the minimum age requirement was reduced by a year for those with 36 years of contributions. The above age requirements apply uniformly to all three pension regimes (retributive, contributive, and mixed). **A 2008 law** allowed old age and seniority pensions to be fully cumulated with labor income. **In 2009,** statutory retirement age of women in the public sector (60 in 2009) was set to increase starting from 2010, to equalize it with age of men (currently 65) by 2018, in response to the European Court of Justice sentence. Furthermore, the 2009 law introduced a five-year indexation mechanism linking the age retirement prerequisites to changes in life expectancy starting in 2015 but implementation mechanisms are yet to be enacted by end-2014.





Plans to develop private pension schemes, however, have not been very successful. Starting January 1, 2007, severance-pay benefits are to be accumulated in funds outside employers. The *Trattamento di fine rapporto (TFR*) is a mandatory benefit that employers traditionally financed by book reserves on behalf of workers to be withdrawn as a lump-sum upon retirement or separation. The default destination for future contributions is private pension funds. Workers have the option to opt-out of private funds, in which case the TFR contributions are held by special fund of the INPS (the National Social Security Institute) on behalf of the Treasury. Progress in the development of TFR private funds, however, suffered a setback following the financial crisis—open and closed funds had substantial financial losses in 2008. This fueled an aversion to the risks of private funds. The funds recovered in 2009 but the early enthusiasm seems to have been lost. By December of 2009, about

5 million workers (only about 1/5 of the labor force) had subscribed to these funds. For the remainder, the severance-pay contributions were transferred to the INPS or remained within the firms.

III. RE-ASSESSING ITALY'S LONG-TERM FISCAL SUSTAINABILITY

A. Why Italy looks good and what are the challenges ahead

At first sight, long-term fiscal prospects for Italy do not appear to raise serious concerns. The authorities' latest projections, based on the envisaged policy scenario (under the excessive deficit procedure requirement of the Stability and Growth Pact) of structural tightening of about 1.8 percentage points of GDP in 2010–12 suggest that public finances are on a long-term sustainable path. Debt would steadily decline to below 40 percent of GDP in 2060, deficit would remain well within the 3 percent of GDP threshold, and age-related spending would stabilize, remaining below the euro area average.

Authorities' Projections
(Percent of GDP, unless otherwise indicated)

	2010	2015	Ave. 2020-60	2060
Total revenue	46.5	46.8	46.7	46.7
Total expenditure	51.4	48.3	47.3	46.0
Age-related	28.3	27.6	28.8	28.6
Pensions	15.2	14.8	15.0	13.8
Health	7.4	7.4	8.4	8.9
Long-term care	1.0	1.0	1.3	1.7
Education	4.2	3.9	3.7	3.8
Interest expenditure	4.9	5.2	2.9	1.8
Overall fiscal balance	-4.9	-1.5	-0.6	0.7
Debt	116.9			below 40
Assumptions (percent)				
Labor productivity growth	1.1	1.3	1.7	1.7
Total participation rate	66.9	69.6	71.0	71.7
Real GDP growth	1.1	2.5	1.4	1.3

Source: Stability Programme Update, Jan 2010.

However, this favorable outlook is subject to a number of challenges. First, under these projections, labor productivity and real GDP growth would have to be well above the growth rates evidenced in past decade. Second, near- to medium-term fiscal adjustment, including in non age-related spending and pensions, has to take place as planned, at a minimum, and more so if growth disappoints or there are slippages in medium-term fiscal consolidation. Third, pressures from health and other age-relating spending should be contained.

Assumptions about future growth and its components are key. In the absence of further broad structural reforms, the expected large increase in long-term productivity cannot be readily assumed. Indeed, the authorities' most recent revisions, which are used in the subsequent analysis, have adjusted the labor productivity growth downwards. However, the assumption that the relatively strong employment dynamics experienced in the past will continue would seem to be at odds with the projected increase in the ratio of inactive elderly to the economically active population.

ANNEX 1: VI. APPENDIX

Table 1A. Age-Related Government Expenditure, 2007–2060
(Percentage points of GDP)

	Pensions			Health care			Long-term care			Unemployment benefits			Education			Total		
	Level 2007	Change 2007 2035	Change 2007 2060	Level 2007	Change 2007 2035	Change 2007 2060	Level 2007	Change 2007 2035	Change 2007 2060	Level 2007	Change 2007 2035	Change 2007 2060	Level 2007	Change 2007 2035	Change 2007 2060	Level 2007	Change 2007 2035	Change 2007 2060
BE	10.0	4.4	4.8	7.6	1.0	1.2	1.5	0.7	1.4	1.9	-0.4	-0.4	5.5	-0.1	0.0	26.5	5.6	6.9
DE	10.4	1.4	2.3	7.4	1.4	1.8	0.9	0.7	1.4	0.9	-0.3	-0.3	3.9	-0.5	-0.4	23.6	2.6	4.8
IE	5.2	2.8	6.1	5.8	0.9	1.8	0.8	0.4	1.3	0.8	0.1	0.1	4.5	-0.4	-0.3	17.2	3.7	8.9
EL	11.7	7.7	12.4	5.0	0.9	1.4	1.4	0.8	2.2	0.3	-0.1	-0.1	3.7	-0.3	0.0	22.1	9.1	15.9
ES	8.4	3.4	6.7	5.5	1.0	1.6	0.5	0.5	0.9	1.3	-0.4	-0.4	3.5	-0.3	0.1	19.3	4.3	9.0
FR	13.0	1.4	1.0	8.1	1.0	1.2	1.4	0.5	0.8	1.2	-0.3	-0.3	4.7	0.0	0.0	28.4	2.7	2.7
IT	**14.0**	**1.2**	**-0.4**	**5.9**	**0.9**	**1.1**	**1.7**	**0.5**	**1.3**	**0.4**	**0.0**	**0.0**	**4.1**	**-0.6**	**-0.3**	**26.0**	**2.0**	**1.6**
LU	8.7	8.0	15.2	5.8	0.9	1.2	1.4	0.7	2.0	0.4	0.0	0.0	3.8	-0.5	-0.5	20.0	9.1	18.0
NL	6.6	3.4	4.0	4.8	0.9	1.0	3.4	2.8	4.7	1.1	-0.1	-0.1	4.6	-0.2	-0.2	20.5	6.9	9.4
AT	12.8	1.2	0.9	6.5	1.2	1.5	1.3	0.6	1.2	0.7	0.0	0.0	4.8	-0.6	-0.5	26.0	2.3	3.1
PT	11.4	0.9	2.1	7.2	1.0	1.9	0.1	0.0	0.1	1.2	-0.4	-0.4	4.6	-0.6	-0.3	24.5	1.1	3.4
FI	10.0	3.9	3.3	5.5	0.9	1.0	1.8	1.7	2.6	1.2	-0.2	-0.2	5.7	-0.2	-0.3	24.2	6.1	6.3
EU27	10.2	1.7	2.4	6.7	1.0	1.5	1.2	0.6	1.1	0.8	-0.2	-0.2	4.3	-0.3	-0.2	23.1	2.7	4.7
EA12	11.1	2.1	2.8	6.7	1.0	1.4	1.3	0.7	1.4	1.0	-0.2	-0.2	4.2	-0.3	-0.2	24.4	3.3	5.2

Source: European Commission (2009).

Table 2A. Parameters of Pension Systems in the Advanced G-20 Countries

	Australia	Canada	France	Germany	Italy	Japan	Korea	UK	US
First Tier 1/									
Social Assistance				24	22				
Targeted	23	16	31					26	20
Basic		14				19	30	20	
Minimum			29					13	
Overal entitlement 2/	23	30	31	24	22	19	30	33	20
Second tier									
Earnings related									
Type	none	DB	DB/points	points	NDC	DB	DB	DB	DB
Accrual rate 3/		0.63	1.75	1	1.75	0.71	0.75	0.89	0.91
Earnings measure		b34	b25/L	L	L	L	L	L	b35
Valorization		w	p/p	w	GDP	w	p	w	w
Indexation		p	p/p	NI+sus	p	p	p	p	p
Defined contribution									
Contribution rate 3/	9								
Ceilings 1/									
Public		100	128	164	357	175	189	156	262
Private/occupational	234		385						
Pension age									
Normal	65	65	60	65	65	65	60	65	66
Early 4/	55	60		63	59(60)	60	55		62

Source: Whitehouse (2008).

DB=defined benefit, NDC=notional defined contribution, b=number of best years, L=lifetime earnings, w=wages, p=prices, NI+sus=nominal income growth and sustainability factor.

1/ Percent of average earnings.

2/ Full career worker.

3/ Percent of individual earnings.

4/ For Italy, the pension access age with 36(35) years of contribution in 2010. The access age is set to increase to 61(62) by 2013. The age requirement is one year higher for the self-employed. A further postponement of about 9–12 months is envisaged through the "exit windows".

Box 1A. Italy's Long-Term Fiscal Outlook: Some Highlights in Numbers

- For *every* inactive person over 65, there were *two* employed persons 15–64 age in 2007; in 2060, the relation will be *nine-to-ten*, the highest in Europe.
- Public debt reached *115.8* percent of GDP in 2009, the second highest to Japan among advanced G-20 countries.
- Public pensions consume *1/3* of budgetary resources or over *15* percent of GDP in 2009, the highest among advanced economies.
- In the absence of the envisaged pension reform, pension expenditure will increase to *24½* percent in 2050, much more than in other advanced G-20 countries.
- The waves of pension reform have helped improve the balance of fiscal adjustment across generations, but the effects of the remaining reform are heavily back-loaded—about *2/3* of the adjustments are expected to happen after 2020 (about 1/2 for the advanced G-20 countries).
- The pension reform is not generationally fair—the net present value of pensions for a current new born are about *75* percent of benefits of a 40-year old and *50* percent of benefits of a 60-year old.
- With no fiscal consolidation in the medium term and lower than envisaged growth in the long run, the public debt will reach over *400* percent of GDP in 2060.
- A *0.2* percentage point increase/decrease in average long-run labor productivity growth translates, other things equal, into about *60* percentage points of GDP decrease/increase in debt-to-GDP ratio in the no-fiscal adjustment scenario.
- *½ percentage points of GDP* increase in the envisaged fiscal structural consolidation in 2011–2012 will cumulate in the long run to *about 35* percentage points of GDP lower debt ratio in 2060.
- Average long-run growth of about *1.1 percent* and fiscal adjustment of *2¼ percent of GDP* in the medium term would be needed to close the sustainability gap but at the debt level close to that of 2010.
- Still, at least a *5* percent nominal cut in overall pension costs (or *0.8* percent of GDP) on average will be needed to bring debt close to 60 percent of GDP by 2060.

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Italy: Selected Economic Indicators, 2004–10

	2004	2005	2006	2007	2008	2009 1/	2010 1/
Real economy (change in percent)							
Real GDP	1.5	0.7	2.0	1.5	-1.3	-5.0	0.8
Domestic demand	1.4	1.2	1.4	1.2	-1.2	-3.5	0.9
CPI (year average, harmonized index)	2.3	2.2	2.2	2.0	3.5	0.8	1.4
Unemployment rate (percent)	8.0	7.7	6.8	6.2	6.8	7.8	8.7
Gross national saving (percent of GDP)	19.9	19.0	19.0	19.4	17.7	15.5	16.1
Gross domestic investment (percent of GDP)	20.8	20.7	21.6	21.9	21.1	18.9	18.9
Public Finance (percent of GDP)							
General government balance	-3.6	-4.4	-3.3	-1.5	-2.7	-5.3	-5.2
Structural balance net of one-offs (in % of potential GDP)	-4.8	-4.6	-3.3	-2.5	-2.6	-3.9	-3.5
Primary balance	1.1	0.1	1.1	3.3	2.2	-0.8	-0.8
Public debt	103.8	105.8	106.5	103.4	106.0	115.8	118.6
Money and credit (end-of-period, percent change)							
Credit to the nonfinancial private sector 2/	5.8	7.7	11.0	9.8	4.9	1.7	...
National contribution to euro area M3 3/	5.1	6.3	7.7	7.6	6.9	5.8	...
Interest rates (end-period)							
6-month interbank rate	2.2	2.6	3.8	4.9	3.7	1.0	...
10-year government bond yield	3.8	3.5	4.2	4.7	4.5	4.1	…
Balance of payment (percent of GDP)							
Trade balance	0.6	0.0	-0.7	0.2	0.0	0.0	0.3
Current account (including capital transfers)	-0.9	-1.7	-2.6	-2.4	-3.4	-3.4	-2.8
Exchange rate							
Exchange rate regime -- euro-area member							
Exchange rate (NC/US$)	1.2	1.2	1.3	1.4	1.5	1.4	…
Nominal effective rate (2000=100)	100.8	100.0	100.1	102.0	104.4	104.5	…
Real effective rate (2000=100)	113.8	112.2	111.9	113.2	115.0	115.8	…

Sources: National Authorities; Eurostat; and IMF staff calculations (April 2010 WEO).

1/ Staff estimates and projections, unless otherwise noted.
2/ Twelve-month credit growth, adjusted for securitizations.
3/ Excludes currency in circulation held by nonbank private sector.