EXECUTIVE BOARD MEETING

SM/20/55
Correction 1

March 11, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Italy—Staff Report for the 2020 Article IV Consultation**

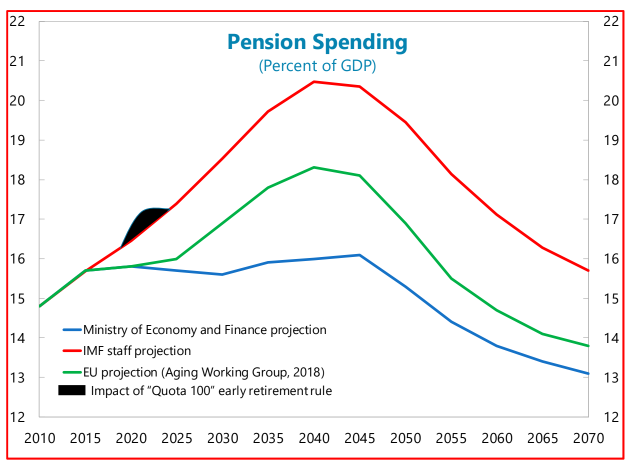
Board Action:	The attached corrections to SM/20/55 (2/28/20) have been provided by the staff:
Evident Ambiguity	**Page 43 (row 7, line 4)**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Page 14**
Typographical Errors	**Page 43 (rows 4 and 7 brackets)**
Questions:	Mr. Goyal, EUR (ext. 36875) Mr. Crivelli, EUR (ext. 36278) Mr. Garcia-Macia, EUR (ext. 30141) Ms. Jirasavetakul, EUR (ext. 39433) Ms. Novikova, EUR (ext. 37447)

recession, debt would rise sooner and faster (Annex IV), heightening the risks of a sharp consolidation when the economy is weakening. It is thus strongly advisable to take advantage of the current low interest rates to implement credible medium-term consolidation.

- Putting credible medium-term consolidation policies in place—via a gradual and balanced adjustment that delivers an overall surplus of ½ percent of GDP by around 2025—would mitigate the need for a sharp adjustment when adverse shocks materialize. Credibility can be built by legislating upfront well-designed measures to promote growth and inclusion (¶s 32–34). Current primary spending should be reduced to achieve fiscal targets, while better focusing social protection to the poor and gradually increasing public investment. Reducing spending would also open room, alongside broadening of the tax base, for lowering the tax burden.

32. **Reducing current primary spending would facilitate achieving medium-term fiscal targets, raising public investment and lowering taxes.** Notwithstanding wage restraint, current primary spending has grown faster than real GDP over the past decade. This is largely due to rising pension spending that has crowded out space for capital spending and tax reductions. Fully implementing procurement reform and recommendations of past spending reviews would yield modest cuts to discretionary spending over time. Thus, options for more ambitious cutting and rebalancing of spending include:

- *Lowering pension spending.* Notwithstanding past reforms, pension spending/GDP is projected to be high and rising in the coming decades. This reflects relatively low employment and productivity growth projections, population aging, and the generosity of the system.[9] The experimental "Quota 100" early retirement rule introduced in 2019 further increased pension spending and introduced a discontinuity in the retirement age that need to be addressed.[10] Staff advises preserving the indexation of retirement age to life expectancy, ensuring actuarial fairness including for options to retire early (i.e., closely linking lifetime benefits with lifetime contributions), and adjusting pension parameters to secure affordability (IMF working paper 18/59).



[9] For instance, replacement rates are 15–20 percent higher than in the EU, the weighted average accrual rate is 2 percent compared to around 1.5 percent in the EU, and benefits are based on relatively short earnings histories and low early retirement penalties.

[10] According to the Quota 100 rule, workers who are at least 62 years of age with a minimum 38 years of contributions are eligible for early retirement during 2019–21. Women who are at least 59 years of age with a minimum 35 years of contributions are also eligible. The potential pool of early retirees was further expanded by allowing workers to fill gaps in their contribution history at subsidized rates. Automatic adjustments of the statutory retirement age to life expectancy were canceled for 2019–20.

Annex II. External Sector Assessment

<table>
<tr><td colspan="7">Overall Assessment: The external position in 2019 is broadly in line with the level implied by fundamentals and desirable policies, based on preliminary staff forecasts. Nonetheless, policies to improve competitiveness are necessary to support growth, reduce high unemployment and public debt, and safeguard the external balance sheet.

Potential Policy Responses: Although the external position is in line with fundamentals, credible medium-term fiscal consolidation is necessary to reduce external vulnerabilities and maintain investor confidence. Structural reforms, including to improve the wage bargaining mechanism to better align wages with productivity at the firm level, as well as efforts to strengthen bank balance sheets, are also critical to improving competitiveness, boosting potential growth, and reducing vulnerabilities. The elements of this package of policies would likely have offsetting effects on the external current account (CA), as they would boost export competitiveness and investment, while being supportive of overall growth.</td></tr>
<tr><td>Foreign Asset and Liability Position and Trajectory</td><td colspan="6">Background. Italy's NIIP reached an estimated -2.5 percent of GDP at end-2019, the highest level since Italy joined the euro. Gross assets and liabilities, however, are estimated at about 159 and 161 percent of GDP, respectively, both about 60 percentage points higher than in 2000. TARGET2 liabilities declined to 25 percent of GDP in 2019 after peaking at 27 percent in 2018, partly reflecting the inflow of reserves to Italian banks following the introduction of tiering by the ECB.[1] Debt securities represent about two-thirds of gross external liabilities, half of which are owed by the public sector. Sustained expected CA surpluses should continue to gradually improve the NIIP.

Assessment. Further strengthening of balance sheets would reduce vulnerabilities related to the high public debt and potential negative feedback loops between the debt stock and debt servicing costs, as well as between sovereign debt and the financial system.</td></tr>
<tr><td>2019 (% GDP)[2]</td><td>NIIP: -2.5</td><td>Gross Assets: 159.0</td><td>Debt Assets: 59.3</td><td>Gross Liab.: 161.4</td><td colspan="2">Debt Liab.: 108.6</td></tr>
<tr><td>Current Account</td><td colspan="6">Background. Italy's CA averaged -1¼ percent of GDP in the decade following euro adoption. Starting in 2013, it moved into balance; by 2017, it registered a multiyear-high surplus of 2.7 percent of GDP, which could be surpassed in 2019 as weak domestic demand is weighing on imports and, hence, boosting the trade surplus. About two-thirds of the improvement from 2013 to 2017 was driven by Italy's growing trade surplus, supported initially by lower commodity prices and subsequently by a rebound in external demand. The rest was due to a higher income balance following the increase in residents' net purchases of foreign assets and a reduction of external liability payments, related not least to the impact of monetary policy. The positive primary income balance also reflects the higher weight of equity in foreign assets than in liabilities. In terms of saving and investment, the improvement in the CA since 2010 is almost entirely due to the increase in gross national saving, while investment over GDP has remained stagnant.

Assessment. The cyclically adjusted CA is estimated at [2.6] percent of GDP in 2019, close to the EBA-estimated CA norm of 2.7 percent of GDP. Staff assesses a CA gap in the range of [-1.0] to [1.0] percent of GDP. Despite the CA being in line with fundamentals, Italy's sizable and long-standing structural rigidities hamper its ability to improve competitiveness.</td></tr>
<tr><td>2019 (% GDP)</td><td>Actual CA: 2.9</td><td>Cycl. Adj. CA: 2.6</td><td>EBA CA Norm: 2.7</td><td>EBA CA Gap: -0.0</td><td>Staff Adj.: 0.0</td><td>Staff CA Gap: 0.0</td></tr>
<tr><td>Real Exchange Rate</td><td colspan="6">Background. From 2018 to 2019, the CPI-based and ULC-based REER depreciated by 3.1 and 2.5 percent, respectively, after appreciating by similar amounts in the previous year.[3] Stagnant productivity and rising labor costs led to a gradual appreciation of the REER since Italy joined the euro area, both in absolute terms and relative to the euro area average, which has partially reversed since 2014.

Assessment. The level and index REER models suggest a modest overvaluation in 2019 of 4.3 percent and 7.0 percent, respectively. This is generally consistent with, but slightly below, the persistent wage-productivity differentials vis-à-vis key partners. It corresponds to a CA gap below the lower end of the staff-assessed CA gap range.[4]</td></tr>
<tr><td>Capital and Financial Accounts: Flows and Policy Measures</td><td colspan="6">Background. Portfolio and other investment inflows typically financed the CA deficits of the past, despite a modest net FDI outflow, without much difficulty. Italy's financial account posted net outflows of [2.9] percent of GDP in 2019, reflecting residents' net purchases of foreign assets. However, portfolio investment shifted from outflows to inflows as foreign investors returned to Italian sovereign debt in mid-2019, with inflows supported further by ~~following~~ the ECB's announcement of extended asset purchases.

Assessment. While supported by ample monetary accommodation by the ECB, Italy remains vulnerable to market volatility, owing to the large refinancing needs of the sovereign and banking sectors as well as the remaining balance sheet weaknesses in some banks.</td></tr>
<tr><td>FX Intervention and Reserves Level</td><td colspan="6">Background. The euro has the status of a global reserve currency.

Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is free floating.</td></tr>
<tr><td colspan="7">[1] Under tiering, deposits at the ECB below a country-level cap of 6 times the minimum reserves requirement benefit from higher rates. Since Italy was the only country below that threshold, it attracted liquid assets from other euro area banks. This is a one-off effect.
[2] Debt assets and liabilities data are for year 2018.
[3] ULC-based REER data is available up to Q3:2019.
[4] The elasticity of the REER to the CA gap is estimated to be 0.26.</td></tr>
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