March 30, 2020
Approval: 4/6/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/6-2

2:30 p.m., January 25, 2019

2. Italy—2018 Article IV Consultation

Documents: SM/18/291 and Correction 1; and Supplement 1; and Supplement 2; and Supplement 3; SM/18/292; and Correction 1

Staff: Goyal, EUR; Bayoumi, SPR

Length: 1 hour. 21 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Tivane (AE), Temporary
	H. Razafindramanana (AF)
	J. Di Tata (AG)
	G. Johnston (AP)
A. Tombini (BR)	
Z. Jin (CC)	
	P. Moreno (CE)
L. Levonian (CO)	
	C. Just (EC)
H. de Villeroché (FF)	
S. Meyer (GR)	
S. Gokarn (IN)	
D. Fanizza (IT)	
M. Kaizuka (JA)	
J. Mojarrad (MD)	
H. Beblawi (MI)	
	R. Doornbosch (NE)
T. Ostros (NO)	
	L. Palei (RU)
	R. Alkhareif (SA)
J. Agung (ST)	
	P. Trabinski (SZ)
	D. Ronicle (UK)
	M. Svenstrup (US), Temporary

G. Bauche, Acting Secretary
H. Malothra, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Central Bank: K. Nikolaou. European Department: N. Belhocine, E. Crivelli, D. Garcia Macia, R. Goyal, A. Kangur, M. Pradhan, P. Thomsen, D. Velazquez-Romero. Fiscal Affairs Department: M. Raissi. Monetary and Capital Markets Department: M. Khamis, M. Savastano. Strategy, Policy, and Review Department: T. Bayoumi, H. Ward.

Executive Director: G. Lopetegui (AG), N. Ray (AP). Alternate Executive Director: D. Ronicle (UK), B. Saraiva (BR). Senior Advisors to Executive Directors: Z. Abenoja (ST), F. Fuentes (BR), M.Gilliot (FF), W. Kuhles (GR), R. Morales (AG), P. Pollard (US), C. Sassanpour (MD), G. Vasishtha (CO), J.Weil (CO). Advisors to Executive Directors: F. Al-Kohlany (MI), K. Badsi (MD), M. Bernatavicius (NO), E. Boukpessi (AF), L. Cerami (IT), J. Hanson (NE), Z. Huang (CC), M. Mulas (CE), B. Parkanyi (NE), T. Persico (IT), N. Vaikla (NO), K. Hennings (BR), J. Montero (CE), A. Tola (SZ).

2. ITALY—2018 ARTICLE IV CONSULTATION

Mr. Fanizza submitted the following statement:

On behalf of the Italian authorities, we thank staff for their informative set of papers and the constructive policy discussion during the Article IV mission.

Background

Italy has suffered from the effects of the double-dip recession that lowered GDP per capita by 12 percent from 2007 to 2013. The crisis has exacerbated some of the adverse impacts of globalization on the Italian economy, and significant portions of the population have been left behind by the following modest recovery, which has not yet brought per-capita income to its pre-crisis level. Moreover, the impact of persistent low growth on public finances has constrained the available resources to address social issues, which have become increasingly pressing. The strategy of the new Italian government, which took office last June, provides a policy response to these challenges by fostering growth and social inclusion while preserving financial stability. My authorities know well that to lift growth in a durable manner they need to implement a comprehensive package of structural reforms. However, the two political parties that are partners in government have chosen to focus on a limited set of measures as specified in a "government contract", on which they could find an agreement. These measures support three major objectives. First, addressing some pressing social issues. Second, taking steps to improve growth prospects. Third, maintaining financial stability by ensuring that social and pro-growth policy are consistent with placing the country's high public debt-to-GDP ratio on a declining path.

Recent Developments

The budget law, adopted on December 30th, ensures compliance of Italy's 2019 budget with the EU fiscal rules and entails a neutral fiscal stance in 2019. The budget law safeguards the new government's social inclusion policies, while ensuring that the debt-to-GDP ratio starts to decline in 2019. The general government deficit is set at 2.0 percent for 2019, 1.8 percent for 2020, and 1.5 percent for 2021. To ensure that the 2019 target is fully met, the budget law introduces a safeguard mechanism that places spending allocations for 2 billion euro (0.12 percent of GDP) in escrow; these resources will be released only if the updated projections as of July 2019 suggest that the budgetary performance is consistent with the target (net of one-off revenues).

The budget law reflects updated official macroeconomic forecasts. Weaker than expected growth in the third quarter of 2018, the sizable reduction in government expenditure compared to the initial draft budget law, and the worsening of leading indicators for the European and global business cycles have led the government to revise down its growth outlook. Growth is now forecast at 1 percent of GDP in 2018 and 2019, 1.1 percent of GDP in 2020, and 1 percent of GDP in 2021.

Despite this weaker outlook, public debt will be reduced from 131.7 to 128.2 percent of GDP between 2018 and 2021. Such reduction reflects: (a) further fiscal efforts, with an improvement of the structural primary balance (which has been positive since 2006) to 2.9 percent of GDP in 2021; and (b) the dismission of government assets in the context of efforts to leverage additional resources for investments in infrastructures and urban renewal. Following the adoption of the budget law, the spread between 10-year Italian and German government securities lowered from the November 2019 peak of over 320 basis points, and today it is at 250 basis points. In 2018, Italy issued 390 billion euros of government securities at an average issuance cost of 1.07 percent. So far, there have not been signs of a pass-through of these levels of the BTP-Bund spread into higher lending rates to the real domestic economy.

My authorities are fully aware of the adverse impact of large and lasting increases in risk premia. However, several factors have enhanced the Italian economy's resilience and have mitigated the impact of the less favorable financial conditions: (a) private sector debt is among the lowest in the euro area; (b) the external position is strong, with a sizable current account surplus and a favorable net investment position that has now returned close to balance; (c) the high average residual maturity of public debt, mostly issued at fixed rates, that slows down the transmission of market interest rates to the average cost of the debt; and (d) the strengthened banking system that has built substantial capital buffers.

The Authorities' Reform Agenda

My authorities concur with staff that the key problems of the Italian economy are low growth and weak social outcomes. To address these challenges, the authorities will reinvigorate public investment, improve the business climate, and design more effective social-inclusion and labor-market policies.

Higher Public Investment

Re-launching public investment is a key element of my authorities' agenda. As a ratio to GDP, public investment has fallen by more than one percentage point of GDP since 2009, and spending for maintaining existing public infrastructures has also declined. Moreover, project implementation time and cost overruns have expanded under the joint effect of poor project preparation and bureaucratic red tape. Thus, both the level and the quality of public investment need to improve. The budget law has introduced several measures to strengthen the central and local administrations' capacities in project planning and management, and the effectiveness of the decision-making process. Simplification of the Procurement Code and the public-private partnership (PPP) framework are also in the pipeline. This enhanced capacity would help invest 118 billion euros, already allocated to public investments and not yet disbursed.

Improving the Business Climate to Spur Private Investment

Actions have already been taken to improve the efficiency of the public administration and to fully implement the reforms legislated in the past. The government is addressing the disparity in the quality of public services across regions through several measures.[1] The government also intends to enhance the digitalization and simplification of procedures. An anti-corruption law that defines stricter measures to detect and prosecute criminal offences against the public administration was adopted in December.

The government adopted a reform that overhauls the bankruptcy and insolvency frameworks in January. The new system introduces: (a) an early warning system to prevent transitory financial distress from turning into fully fledged economic crises; (b) more effective creditors' involvement; (c) streamlined procedures and a framework to manage the insolvency of more companies in a group; and (d) measures to facilitate the debt discharge of small businesses and consumers. Moreover, recently adopted laws aimed at favoring a more effective management of non-performing loans (NPLs) have helped reduce the time it takes to sell assets in foreclosing procedures.

[1] These measures, among others, include: (a) multi-year plans to improve the quality of services with measurable outputs and well-defined managerial responsibilities; (b) creation of a central unit tasked with monitoring results and imposing corrective actions; and (c) more targeted hiring procedures.

The reforms of the civil justice and the reorganization of courts implemented in previous years are making an impact. The number of the on-going civil proceedings and the backlog have dropped, as the on-line civil trial has become operational. The length of proceedings is still high; however, the trend clearly signals a reduction of civil trials' disposition time. The government is determined to further improve effectiveness and efficiency and plans to further streamline civil proceedings and hire more judges.

The government intends to review the personal income tax and harmonize it with the corporate income tax to reduce the tax burden. In order to implement these reforms in a sustainable manner, however, broad discussions are needed to build consensus and to secure budget resources, which will require time and extensive work. In the meantime, the budget law extended a flat tax regime for low and middle income individual entrepreneurs, artisans and self-employed workers and provides a tax incentive on reinvested profits.

Job Market and Social Inclusion

To improve the functioning of the job market, the government is introducing active labor market policies that – in addition to providing protection against poverty – will help job seekers preserve human capital, reduce the costs of job search, and eventually facilitate the matching of supply and demand. Key measures are: (a) the introduction of a citizenship income to be granted to those who are actively engaged in job search and/or training; and (b) the strengthening of the regional centers assisting job seekers to identify vacancies. The citizenship income will capitalize on the experience of the current inclusion income program.

To remove distortions and the unequal treatment of age-cohorts determined by previous reforms, the government has introduced corrections to the current pension system. Specifically, early retirement under flexible rules (workers with at least 62 years of age, and 38 years of contribution) will be allowed for a 3-year window. These provisions do not reverse previous reforms, including the indexation of retirement age to life expectancy, and preserve actuarial fairness. My authorities believe these measures will help address the widespread social discontent that past reforms have determined and could foster youth employment and labor productivity.

Banking Sector

The Italian banking sector has proved resilient, thanks to increased capital buffers, improved credit quality, and growing disposal of NPLs. Wholesale funding costs remain around their lowest since the beginning of the century. Nevertheless, my authorities remain fully committed to further strengthening banks and safeguarding financial stability, building on the substantial advances achieved in recent years. Further enhancing capitalization, efficiency, and profitability, most notably by diversifying sources of revenue and reducing operating costs, remain key priorities.

Banks have strengthened their capital base since the onset of the Great Financial Crisis. The Common Equity Tier 1 ratio reached an average of 13.1 percent in September 2018, up from 7.0 percent at the end of 2008. This strengthening took place amid the enforcement of stricter rules on minimum capital requirements (Pillar 1) and supplementary requirements by supervisors (Pillar 2).

The credit quality has improved substantially, reflecting both strict supervisory oversight and prudent risk taking by banks. The ratio of new NPLs to total performing loans stood at 1.7 percent in the third quarter of 2018, down from 6.1 percent at end 2009; the current ratio has dropped below its pre-crisis levels.

The burden of outstanding net NPLs on Italian banks has shrunk to less than 5 percent of banks' total loans. Gross NPLs dropped to 216 billion euro at end September 2018, from a peak of 360 billion euro at end 2015. Over the same period, net NPLs fell to 99 billion euro from 197 billion euro, with a coverage ratio that increased by 9 percentage points to 54 percent. The development of a secondary market for NPLs has played a key role behind this reduction, allowing the disposal of gross bad loans for 80 billion euro over the period. Both the government guarantee on the securitization of bad loans (introduced in 2016 and set to expire in March 2019) and the analytical reporting of bad loans launched by Bank of Italy in 2016 have helped the secondary market to develop.

My authorities are committed to further strengthen and cement the progress made in recent years. To help banks become more proactive in managing their NPLs, the Bank of Italy issued guidelines on NPL reduction strategies for Less Significant Institutions in January 2018 and is currently evaluating the plans submitted by banks. Measures to reduce NPLs, restore profitability and strengthen balance sheets are particularly important, considering the ongoing transformation of the financial sector and the need to adapt to the new approaches to banking regulation and supervision. It also remains critical for banks to resolutely pursue strategies to tackle the challenges of technological development and competitive pressures.

Mr. Meyer submitted the following statement:

We thank staff for their comprehensive and insightful set of papers in the context of Italy's Article IV consultation, which usefully reference a wide set of recent staff analysis on Italy. We also thank Mr. Fanizza for his informative buff statement.

The staff report rightly points out the many risks and vulnerabilities that the Italian economy is facing and makes a compelling case for deep structural reforms. We broadly share staff's analysis. Growth in 2017 was highest in a decade, the employment rate has increased, the external current account surplus has been maintained, and the banking sector made big strides in repairing its balance sheet. This being said, we agree with staff that economic policies must be keenly directed at addressing the most acute problems: low productivity, high public debt and weak social outcomes. Furthermore, continued efforts are needed to improve banks' balance sheets, which could suffer from sustained high sovereign yields. We strongly encourage the authorities to tackle these challenges without delay and welcome in this regard Mr. Fanizza's buff statement which indicates that these issues are on the Italian authorities' agenda. We share staff's concerns that the authorities' structural reform strategy falls short of the comprehensive reforms needed and that the government's flagship measures, as also indicated in staff's latest supplementary information, might not go in the right direction.

Macroeconomic developments

We take note of staff's updated macroeconomic projection with GDP growth of 0.6 percent for 2019 and 0.9 percent in 2020. Persistent structural weaknesses prevent the Italian economy from exploiting its full potential. The staff report gives a thorough assessment of Italy's economic woes. This includes income per capita levels that are unchanged from where they had been two decades ago and over 20 percent of households being at risk of poverty. On the positive side, however, we highlight positive labor market developments, with employment and labor force participation at historical highs, and positive signs of improving credit flow to the private sector also due to continued reduction of balance sheet risks in the banking sector. The

Italian economy shows elements of resilience, such as the low private debt, the net international investment position and the current account surplus.

The recovery of the past few years with growth rates outpacing potential growth might be coming to an end. Notwithstanding the large uncertainties around the potential growth estimates of the Italian economy, the fact that growth may have stalled in the third quarter of 2018 while the output gap has not been closed seems to underline staff's assertion that structural rigidities create a substantial drag on growth. Thus, we share staff's view that supply side measures, such as increasing labor market flexibility and boosting productivity by promoting a stable and investment-friendly environment are indispensable for setting the economy on a higher growth path. We welcome the authorities more realistic updated economic forecast.

Fiscal policies

We welcome that the modified budget for 2019 now avoids a deterioration in the structural fiscal balance. We share staff's view regarding the sizable risks the high Italian public debt level poses to the banking sector, which is a significant holder of government debt, and that could feed into the real sector through higher funding costs. We therefore welcome the authorities' intention to put public debt on a firm downward path. However, the net economic effect of the budgetary measures is surrounded by a significant degree of uncertainty. There are currently limited signs of funding cost pass-through to the economy, also due to the fact that the Italian banking sector has a comfortable liquidity position, including the use of the ECB's TLTROs. Nevertheless, readiness to adapt to a rapidly changing environment will be important to deliver on the goal of reducing public debt and to comply with the EU fiscal rules. In this context, we welcome the safeguard mechanism built into the budget and would strongly encourage its use if necessary.

We support staff's recommendation to pursue a gradual and growth-friendly fiscal consolidation with a view to achieve a small structural surplus over the medium term. We broadly concur with a consolidation pace of 0.5 percent of GDP per annum starting in 2020, which is broadly consistent with the requirements of the SGP's preventive arm. We note that further increasing sovereign bond yields could pose a challenge to achieving the budgetary objectives. Also, to embed the benefits of the planned fiscal adjustment, the quality of public finances must be improved. We therefore are concerned by the recently approved temporary 3-year window that allows early retirement. Staff's analysis that the risk of poverty is higher among younger generations than among pensioners is instructive in this regard. We also concur with staff that productivity-enhancing public investments should be increased without jeopardizing fiscal targets. Finally, there is room to improve Italy's social and tax systems through modernizing the safety net and lowering tax wedge on labor while broadening its base.

Structural policies

We welcome the authorities' commitment to structural reforms, however, when it comes to the labor market, reforms could be more targeted to bringing labor costs in line with productivity. We concur with staff's view that economic policies should focus on improving labor market outcomes (for young persons, employees and unemployed people); such policies can also contribute significantly to wider social objectives. We understand that the new government's reform agenda aims to tackle important structural issues, such as low levels of investment, cumbersome market entries and exits and high tax burden on labor. We welcome that the budget law has introduced measures to strengthen the central and local administrations' capacities in investment project planning and management, and the effectiveness of the decision-making process, as described in Mr. Fanizza's buff. As shown in staff's analysis, productivity has been declining whereas labor costs relative to other euro area economies have grown significantly. Therefore, we note staff's proposals for decentralizing the wage bargaining system, liberalizing the services market, reforming the public administration and modernizing the insolvency system. While a regional differentiation of wages should help improve competitiveness of low-productivity regions, a firm-level wage bargaining process should be achieved to account also for the firms' size and structure. We note that a reform of the insolvency system has been adopted as well as a new anti-corruption law, and that the process for a law to reform the public administration has been started. We look forward to staff analysis in the context of the next consultation.

Financial market policies

Important progress in repairing banks' balance sheets has been made that must continue to further strengthen their capital base and hence resilience. The reduction in NPLs achieved so far is substantial: the stock of gross NPLs has dropped by more than one third since its peak in 2015, thanks to both large sale transactions and lower new NPL inflows. The creation of a secondary market for these distressed assets was instrumental in this achievement. However, at around 5 percent of total loans in net term and 10 percent of total loans in gross term, the stock of NPLs still needs to be lowered and its further reduction crucially depends on increasing the efficiency of judicial processes that would shorten the recovery time and increasing the value of collateral, thereby narrowing NPL bid-ask spreads. We take positive note that the measures on judicial proceedings adopted in the past are having some positive impact; however further action is needed, and we welcome that this is included into the authorities' agenda.

As staff notes, the authorities should aim at further reducing the risks related to the sovereign-bank nexus. Banks' higher capital ratios, lower NPL ratios, improved oversight and resolution frameworks have already reduced the possible spillovers. Economic and budgetary policies must be improved too, to prevent large increases in government bond yields for a long period of time that would negatively affect banks' capital.

Ms. Levonian, Ms. McKiernan and Mr. Weil submitted the following statement:

We thank Staff for their assessment of the current challenges facing the Italian economy and Mr. Fanizza for his comprehensive buff statement. We agree with the central conclusion that the overarching priority for the Italian authorities should be the implementation of structural reforms to lift potential output growth. It will be crucial to put public finances on a sustainable footing not only to build buffers, but to make spending more inclusive, to calm market concerns regarding fiscal sustainability, and to reign-in sovereign yields and their associated potential pass through to bank funding costs. We welcome the recent resolution of the budgetary discussions between Italian authorities and the European Commission but note that the deferral of certain fiscal plans underpinning Budget 2019 will not substantially alter Italy's growth path or fiscal paths. We agree with staff that overall risks remain tilted to the downside, particularly given fiscal and financial sector vulnerabilities.

We welcome the authorities' commitment to structural reforms, although we share staff's concerns that they fall short of the comprehensive plans needed. Structural reforms need to be vigorously pursued to achieve higher potential output growth. While we recognize their political economy implications, bold labour market reforms would help boost Italy's low employment and participation rates, and lower structural unemployment. Beyond labour market reforms, we agree with staff that there is a pressing need for the authorities to promote competition by reducing barriers to entry, especially in the retail sector, and tackle public sector inefficiency. Staff's proposal to decentralize wage negotiations is likely faced with major political economy constraints. Such a proposal would also have profound migratory impacts for Italy. Could staff comment on how such a proposal could be implemented incrementally, or whether there are other measures that the authorities could take to address wage distortions over time?

The authorities should consolidate public finances to put debt on a firm downward path and also make spending measures more inclusive. Absent a plan to boost revenues and reign-in spending, current primary surplus projections will be insufficient to overcome poor growth prospects and prevent a rise in debt to GDP in the medium term. In a first instance, the authorities should focus on improving the integrity of the tax system by increasing compliance rates. We support staff's proposal to introduce a modern property tax system to redistribute some of the tax burden to wealthier households. The authorities should also seek ways to make the composition of spending measures more growth-friendly and inclusive. The authorities' efforts to improve the efficiency of the public pension system in recent years have been welcome, but the recent proposed lowering of the retirement age could carry a heavy fiscal burden and raise questions of inter-generational fairness. Further, pension spending may also be crowding-out social spending that could otherwise be targeted to the most vulnerable in society. The authorities should monitor labour market data closely for signs of unintended policy outcomes of planned pension reforms, such as a lowering of overall labour demand by firms.

Bank funding costs are increasing, amid widening sovereign spreads, and substantial redemptions on the horizon would be expected to exacerbate them. We were very encouraged by Mr. Fanizza's observation in his buff that Italy's average issuance cost in 2018 was 1.07 percent, and that spreads have moderated significantly from their November 2018 peak. This stands in sharp contrast to Box 3 of the Staff Report, which paints a somewhat alarming picture of Italian spreads, the sovereign-bank nexus, and forward bank funding requirements. Large bank holdings of sovereign bonds are pressuring bank funding costs and, while the pass-through to borrowing costs for households and firms has so far been limited, this remains a key risk to monitor. Banks need to make plans to deal with very substantial redemptions of the ECB's low-cost longer-term refinancing operations in 2020-21. From a financial sector perspective, it will also be important for the authorities to address barriers to the credible deployment of the bank resolution toolkit. Lastly, we welcome plans for smaller banks to consolidate into banking groups, as it will lead to more effective supervision and stress testing alongside potential efficiencies.

Mr. Agung and Mr. Abenoja submitted the following statement:

We thank staff for the comprehensive and interesting set of reports, and Mr. Fanizza for his insightful buff statement.

While the recovery in the Italian economy in the past few years was driven in part by favorable euro area growth and accommodative monetary conditions, recent reports observed a slowdown in economic activities in Q4 2018. Considering that real per capita incomes remain at levels similar to those of two decades ago and unemployment remains elevated, we welcome the authorities' ongoing focus on policies to support growth and improve social outcomes. At the same time, we note the significant headwinds including concerns on debt sustainability, a possible increase in banks' funding costs, and low productivity. These challenges emphasize the need for a well-calibrated fiscal consolidation anchored on growth-friendly policies and inclusive measures, further strengthening of bank balance sheets and a continued commitment to structural reforms. In this light, we concur with the broad thrust of the staff appraisal and offer the following comments for emphasis.

A credible fiscal consolidation program is imperative to steer the public debt ratio towards a more sustainable path while preserving social spending for the vulnerable sectors. We commend the authorities for their emphasis on raising public investment and assisting the poor and unemployed as part of the fiscal stimulus package. This is particularly important to help underpin public support for economic policies. However, staff estimates suggest that the size and composition of the stimulus program could lead to a deterioration of the primary surplus and would remain inadequate to put the fiscal debt on a firm downward trajectory. Could staff elaborate on the implications of the recent revisions in the fiscal stimulus plan on the debt sustainability assessment, including the general path of the Debt-to-GDP ratio?

To help contain the fiscal deficit, we agree with the staff recommendations to reinvigorate revenue mobilization by continuing to broaden the tax base and strengthening tax administration. In terms of expenditure, focus could be on reducing current primary spending supported by improvement in budget implementation capacity as well as the conduct of a comprehensive review of the social protection system to better enhance its effectiveness.

We welcome the authorities' efforts to further strengthen the banking sector's balance sheet and governance to help promote financial stability. Progress has been achieved in improving the health of the banking system particularly in terms of the reduction in non-performing loans, increase in capital, and gradual rise in profitability. We note positively the authorities' recognition of the need to consolidate the small cooperative banks as well as the importance of timely recapitalization or resolution of problem banks. We encourage the authorities to build on these gains to further fortify the system's resilience to shocks and expand its capacity to support economic activity. The intensive oversight of significant banks should be continued and extended to cover smaller banks with asset quality issues. Governance should also be enhanced with the full application of the fit and proper guidance for bank management.

Continued commitment to an ambitious structural reform program is a key element in enhancing economic resilience, raising productivity and accelerating potential output growth. We support the authorities' legislative initiative to address corruption and reduce red tape, and concur with staff's assessment that more effort should be devoted to advance the reform agenda to address labor market rigidities and enhance competition policy. To this end, to reduce structural unemployment, the authorities may consider implementing mechanisms to further decentralize wage bargaining to better align wage adjustments with productivity at the regional and firm levels. This can be complemented by the on-going enhancements in active labor market policies to improve matching of labor demand and supply. We appreciate staff's comments on the capacity of local administrators to implement the active labor market programs as envisioned in the Jobs Act. To promote competition and improve the business environment, we agree with the staff recommendation to continue the liberalization of the services sector. We are also pleased to note the January 2019 reforms to overhaul the bankruptcy and insolvency framework. Effective implementation of these reforms will contribute to lifting productivity, improving competitiveness and expanding the potential capacity of the economy. With the adoption of structural measures in previous years and the on-going reform process combined with growth in capital formation over the near term, could staff elaborate on the underlying factors behind their assessment of a marked decline in productivity between 2017 and 2018 (see Table 1 page 32 of the Staff Report; Table 1 page 4 of Supplement 2)? Could staff also briefly clarify the prioritization of the remaining proposed reforms to take advantage of possible synergies across these measures and help ensure an orderly reform process?

Mr. Ostros and Mr. Gade submitted the following statement:

We thank staff for their reports and Mr. Fanizza for his informative BUFF statement. Italy has for long been struggling with low economic growth due primarily to structural economic weaknesses. These structural dampeners on economic growth are compounded by the high level of public debt being a perennial source of vulnerability. Staff's report and recent analytical work is very rich on policy recommendations to lower the structural rigidities and raise growth. We share staff's concern that the authorities' economic policy strategy falls short of the comprehensive reforms needed to turn Italy around, and that the authorities' current policies risk leaving Italy vulnerable in the next global downturn. This vulnerability carries potential economic and financial spillover risks, not least in the euro area, where Italy is of systemic importance. We broadly agree with the content of the staff appraisal but would have appreciated a more thorough assessment of the sovereign-bank nexus and the potential economic and financial spillover risks. We associate ourselves with Mr. Meyer's statement, and offer the following comments for emphasis.

High public debt, the composition of fiscal policy, and the planned fiscal stimulus further ahead may do little to enhance growth prospects and leave Italy vulnerable for the next downturn. We commend the Italian authorities for having created the basis for a stable debt to GDP level through successive years of primary surpluses. In addition, the public debt profile is skillfully managed. However, staff's public DSA risk assessment is flashing red on most indicators. The large gross financing needs is a vulnerability to Italian and regional financial stability, and the higher financing costs more generally a dampener on investment activity and economic growth. We agree with staff that there is a strong need to place the debt trajectory on a firm downward path to increase confidence and to lower credit risks and costs. We strongly encourage the authorities to consider staff's recommendation of a gradual fiscal consolidation, supported by a shift in composition to promote sound growth and social inclusion. Staff's projection of future pension spending clearly indicates a need to tackle pension reform early on, and to err on the side of caution. Meanwhile, we are less convinced of staff's recommendation of bringing public investments back to pre-crisis levels, a level which may generally not be the best benchmark.

A growth-supporting fiscal policy needs to be accompanied by labor and product market reforms, stronger competition policy, and an improved business climate. Given Italy's recent history of low growth, including potential growth, staff is rightly pointing to the need for a comprehensive reform package. Given the increase and level of structural unemployment, the low labor force participation rate, and regional differences, staff rightly explores a multitude of ways to increase labor market flexibility and participation. In terms of reducing barriers to competition in product and services markets, the adoption of the annual competition law was a step in the right direction, and we urge continuation including through strengthened enforcement. The authorities' intention to advance public sector reform, modernize the insolvency framework, and fight corruption is welcome, and reform implementation in these areas should also lead to a needed improvement in the business climate. Overall, staff's simulations indicate that such a reform package would increase GDP sizably over a 10-year period. Although the growth effect would not kick-in until after some years, it is noteworthy that the structural elements of the reform package, essentially yield a positive GDP effect throughout their existence. Reforms do take time to yield results, and we would therefore strongly encourage the authorities not to roll back the reform efforts of recent years.

The important progress in improving bank balance sheets should be continued and broadened. We note in staff's appraisal that problem assets have been reduced sharply, capital levels have increased, and profitability improving gradually, which is a welcome development. The SSM has played an important role in this development for the systemic banks. We agree that it is important with a similar strong oversight of NPL reduction strategies for non-systemic banks. Staff points out that tackling some of the problem banks continue to burden the system, and we agree that swift recapitalization of problem banks or a timely and effective use of the resolution framework is essential to bolster confidence in the financial system. Relatedly, it should be continuously strictly monitored that banks ensure they have adequate bail-in-able instruments and viable business models, proactively managing risks and addressing capital depleting business lines, in the years ahead. Finally, the report could have explored in more detail remaining challenges and implications of the domestic banking sectors' holdings of Italian public debt, reinforcing the sovereign-bank link as described in paragraph 11.

The assessed modest overvaluation of the real effective exchange rate supports the recommendation of structural policies to lower relative unit-labor costs. We note that staff assesses that the external balance is broadly in line with fundamentals, and that the current account has been in a relatively stable surplus around 2 percent over the most recent years. Staff still assesses the real effective exchange rate to be modestly overvalued in part due to relatively higher unit-labor costs. Looking ahead, staff is projecting the current account to narrow further. We agree with staff that a comprehensive reform effort would support external competitiveness, add to investor confidence, and reduce external vulnerabilities.

Mr. Tombini and Mr. Fuentes submitted the following statement:

We thank staff for the papers and Mr. Fanizza for the insightful statement. After a brief recovery in 2016-17, economic activity in Italy is slowing down as structural bottlenecks and legacy issues continue to challenge the effectiveness and sustainability of macroeconomic policy. Moreover, pressing social needs add to the challenging environment and urge for policy action. Against this background, the prospective fiscal stimulus planned by the new government tries to ease social hardships and could contribute to reinvigorate growth in a context of less accommodative monetary conditions. Yet, considering the state of public finances, any fiscal expansion should be well-targeted and modest, and supported by a reform agenda to boost productivity, public sector efficiency and governance.

The fiscal stimulus package benefits economic activity in the near term but raises risks to the medium-term outlook. Reinvigorating capital investment is a key component of the stimulus plan that will contribute to near-term and future growth in Italy. Similarly, expanding social protection and pension benefits will help alleviate rising socioeconomic tensions. Staff is skeptical about the sustainability of this approach and warns that postponing fiscal consolidation and a comprehensive tax reform may result in a sustained rise in the fiscal deficit towards 3 percent of GDP in 2019-21. Has staff assessed the fiscal stance entailed by the recently adopted 2019 budget, which resulted from a compromise with the European Commission? We acknowledge that this is a risky juncture in which a delicate balancing act needs to be performed in order to ensure both fiscal and social sustainability for the needed adjustment and reforms.

High public debt remains a key vulnerability. Insufficient, albeit sustained, structural primary surpluses and lingering rigidities in public spending continue to hinder efforts to reduce public debt in Italy, which currently stands above 130 percent of GDP. Staff baseline scenario projects the debt-to-GDP ratio to remain broadly stable in the near term, absent further fiscal consolidation measures. Nonetheless, adverse demographic trends and any undue fiscal expansion could further weaken the stabilizing influence of recent pension and healthcare reforms in a context where the accommodative monetary policy stance fostered by the ECB has started to be reversed. Under such circumstances, the economy could be vulnerable to risks of a premature and faster rise in debt. Therefore, advancing the structural reform and continuous fiscal adjustment are crucial for sustained debt reduction and medium-term fiscal sustainability. We welcome Mr. Fanizza's statement that the authorities are planning to take measures that would yield an additional cumulative improvement in the structural primary balance of 2.9 percent by 2021. Together with privatization revenues and an improved growth performance, those could, according to the authorities, reduce public debt by 3.5 percent of GDP in the period.

Completing reforms and fully implementing measures to boost productivity and potential output should remain a priority to support growth strategy. Like in many advanced and emerging market economies, productivity growth in Italy has been stagnant, principally among SMEs. While the authorities concur with the need to increase potential growth, their economic policy package is mainly aimed at supporting aggregate demand to narrow the output gap. We strongly believe measures to strengthen the supply side of the economy should also be placed at the forefront to tackle the widening gap in productivity factors between Italy and its peers.

Structural rigidities in the labor market need to be addressed to reduce unemployment. While labor market indicators have shown commendable improvement bolstered by earlier growth spurt, market performance is still undermined by lingering structural issues. For years, the Italian labor market has been characterized by lack of flexibility, low participation rates, particularly among the youth, and broadening wage and productivity growth misalignment, contributing to high structural unemployment and impairing business competitiveness. The 2014-15 labor market reforms, encompassed in the 'Job Act', contributed to bring labor market institutions closer to European benchmarks and "flexicurity" principles. Furthering reforms and measures to boost labor market institutions efficiency and flexibility are essential to promote job creation and competitiveness.

Overall financial sector health is improving but continued improvement in banks' governance and balance sheets remain necessary. Asset quality has improved as efforts to address the legacy stock of nonperforming loans (NPLs) on banks' balance sheets are bearing fruit, and the number of new NPLs has declined close to pre-crisis levels. We wonder how critical a role was played by secondary markets on this development. Moreover, deposits have increased, and liquidity remains comfortable after recent consolidation and restructuring in the banking system. Since the GFC, banks have strengthened their capital base amid enhanced enforcement of stricter regulatory requirements. We welcome the recent overhaul of the insolvency and bankruptcy frameworks and would appreciate to hear staff views on their key features. Notwithstanding the progress, further actions to improve governance, strengthen resilience and improve banks' balance sheet health are warranted to buttress financial stability.

Mr. Moreno submitted the following statement:

General appraisal. We thank staff for its comprehensive set of papers and Mr. Fanizza for his informative buff statement. We generally share staff's appraisal, in particular: on the diagnostic, the focus on weak social outcomes, low productivity and high public debt levels as the main long-standing problems of the Italian economy; and, on the recommendations, staff's call for an adequate combination of ambitious structural reforms and a sustainable and better-targeted fiscal policy that sets a debt-reducing path, while promoting at the same time a more inclusive growth pattern. We note that this general approach is also shared by the authorities' three main objectives, as summarized in Mr. Fanizza' s statement: addressing pressing social issues, improving growth prospects, and following a declining path for the public debt-to-GDP ratio consistent with a social and pro-growth fiscal policy. We associate ourselves with Mr. Meyer's remarks on his statement and will focus our comments on fiscal policy and structural reforms.

Fiscal policy. We welcome the authorities modified budget for 2019 based on a more realistic economic forecast and the reduced deficit targets for 2020 and 2021. The new budget now implies a neutral fiscal stance in 2019 (when accounting for -0.2 one-off measures) and delays the structural adjustment for the medium term. While the new fiscal targets have stopped the excessive deficit procedure under EU fiscal rules—notwithstanding the review in May based on spring forecasts and final 2018 data—we would stress that the structural adjustment path is far from the SGP's preventive arm requirements. The new fiscal path largely relies on temporary and uncertain measures such as delaying expenditures or the strengthening of the revenues safeguard clause (raising TVA and excise duties). Fiscal targets could further deviate if growth were weaker than projected. In this respect, we support staff's recommendation to design a 2.5 percent consolidation path for a four-year period that ensures a sustained downward path for public debt levels that would be broadly consistent with EU fiscal rules. This effort will likely require a shift in the composition of expenditures and revenues to better target growth and inclusion. We welcome that staff's report focuses on fiscal structure, including on the selected issues paper, which can provide useful input for the authorities in this key challenge.

[A note to SPR on transparency policy. The supplement on Italy's new budget provides yet another example where the publication of the Art. IV is clearly outdated because significant developments have occurred after the cut-off point (in this case, December 18, more than one month ago), but before publication. This is one of the issues that should be addressed in the next transparency review.]

Structural reforms. The report rightly places a strong emphasis on an ambitious and comprehensive package of structural reforms as the necessary complement to fiscal policy on the supply side to address Italy's long-standing problem of low productivity. Notwithstanding the measures announced by the government, as stressed in MR. Fanizza' s statement—including the reform of the bankruptcy framework or the measures to improve the efficiency of public administration—we would highlight the need to enhance competition, reduce public sector red tape, and improve the business environment, including administrative burdens for foreign investment. Italy ranks very low on institutional indicators such as Doing Business or Transparency International, in comparison with its level of income. On the labor market, we welcome the recommendation to set a minimum wage for sectors not subject to collective bargaining and strengthen ALMPs. We would also stress the need to undertake measures to foster women participation rates. On the financial sector, we welcome the authorities' commitment to continue reducing NPLs and strengthening balance sheets. We would also highlight the need to address the restructuring and consolidation of cooperative banks.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the informative reports and Mr. Fanizza for his insightful buff statement.

Despite a recovery in the last few years, Italy's economic conditions have remained weak owing to overhang of debt and heightened risk of recession. At the same time, high incidence of poverty and unemployment are concerning. We support staff advice presented in SI paper on implementing well-designed modern safety nets and programs to incentivize regular work and implement tax reforms supportive of support labor supply. We note though that the new Government's plans for fiscal stimulus, inter alia, to support public investment, expand pension benefits and social protection have raised debt sustainability concerns. We are, however, encouraged by the recent reconciliation of the fiscal plans of the 2019 budget with the EU fiscal rules. In the revised fiscal plan encapsulated in 2019 new budget law Italy is obliged to cut budget deficits between 2019 and 2021, which would put the debt trajectory on a downward path. Staff nevertheless remains concerned about the resurgence of renewed challenges which might impair market confidence and hamper recovery.

The downside risks to Italy's economic prospects stem from the likely inability to access markets at sustainable yields and its impact on public and private borrowing costs that could result in rating downgrades of the sovereign and banks. Besides, mounting international trade tensions are worrisome since any pronounced market stress could potentially translate into adverse spillovers at the global level due to wider exposure to Italian debt.

Fiscal policy is at the heart of economic policy actions. The projections for growth and deficit over 2019 to 2020-21 in the initial budget law appear in contrast to the agreement reached with EU fiscal rules. While the authorities projected the 2019 deficit at 2.4 percent, the recent agreement enshrined in the revised 2019 budget law has proposed 2 percent- and further 1.8 percent and 1.5 percent in 2020 and 2021, respectively. At the same time, worsening leading business cycle indicators have led to downward revision in growth projections over the period 2018 to 2021. Taking these developments together, could staff provide their internal assessment of Italy's debt stock in 2021 compared to the authorities' estimate. We concur with staff that given the burden of large debt, a balanced consolidation with a mix of growth and poor friendly policies would serve to sustain fiscal stability. This mix of policies should include rationalization of the pension system through actuarial assessment, enhancement in productive and efficient capital investment, measures to alleviate poverty and increase in social protection to incentivize regular work and improvements in the efficiency, progressivity, neutrality and fairness of the tax system.

We note that although the capital buffers and asset quality of banks have improved, rising sovereign yields in the context of market concerns about fiscal policy continue to raise fears about risks to banks' solvency and capital ratios. In addition, rising costs of funding would impact banks' plans to raise capital, reduce investor interest and enhance NPL cleanup and provisioning costs. We encourage the authorities to ensure speedy resolution of banks' outstanding NPLs while taking further measures to strengthen capital buffers, enhance operational efficiency and profitability. These initiatives would serve to restore the health of banks. Reorienting business models for improved risk pricing and profitability, enhancing governance and consolidating smaller banks would strengthen the resilience of the financial system. We welcome the commitment of the authorities to reinforce the progress made in strengthening the banking system and safeguarding financial stability. In view of the bail-in challenges faced by banks in the past, could staff comment on the types of bail-in instruments that could be considered more suitable in future? We welcome the authorities' commitment for improving banks' efficiency and profitability.

We observe that Italy is facing weak social outcomes, low real personal incomes, high unemployment and erosion of living standards of the middle-aged and younger generation. Structural reforms such as aligning wages with productivity, implementing ALMPs, increasing product and service market liberalization, reforming public administration and judicial systems would help in unlocking Italy's economic potential and spur investment, growth and employment. We welcome the authorities Reform Agenda comprising of initiatives aimed at reinvigorating public investment, improving business climate and designing more effective social inclusion and labor market policies. The recent modernization of the general insolvency framework which, inter alia, includes effective creditor involvement is appreciable, as are the steps aimed at reining corruption, reducing red tape and simplifying administrative procedures. We concur with staff that further progress is required for streamlining procurement and reforming state-owned enterprises.

We wish the authorities the best and every success in future endeavors.

Mr. Just and Mr. Stradal submitted the following statement:

We thank staff for an insightful and candid set of papers and Mr. Fanizza for his helpful buff statement. The economic uptick in 2017 and early 2018 has waned with growth slowing to a halt and the risk of a recession rising. The near-term significant downside risks exacerbate the poor long-term performance of the Italian economy, reflecting deep structural problems, a very high government debt ratio, and the banking sector's elevated exposure to sovereign risk. The resulting secular deterioration of Italy's competitiveness urgently requires the determined effort by the authorities to enhance potential growth and implement a credible and sustainable fiscal consolidation strategy. We associate ourselves with Mr. Meyer's statement and add the following comments.

We welcome that the revised budget, approved by the Italian Parliament at the end of December, moderated the originally envisaged fiscal expansion plans. However, the debt sustainability analysis clearly shows that a more ambitious comprehensive fiscal consolidation plan is critical. We take note that Italy's debt ratio has been locked at a highly elevated level despite the tailwinds from the low interest rate environment and the ECB's asset purchase program. The unwinding of the latter and the gradual interest rate normalization, combined with growing ageing related spending pressures, pose a major threat to the sustainability of public debt. The room for fiscal response as the macroeconomic outlook deteriorates is thus severely constrained. Against this background, we would appreciate a preliminary assessment by staff how the fiscal costs of the temporary reversal of past pension reforms and of the introduction of the citizenship income program which were approved by the Italian government last week will alter the debt sustainability calculations? We fully support staff's call to aim for a small surplus by better targeting social spending, containing the pension spending pressures, broadening the tax base, and improving the tax compliance, while avoiding tax amnesties.

We welcome the progress achieved in strengthening the banking sector aggregate balance sheet, as well as the authorities' commitment to further strengthen capitalization and thereby safeguard financial stability. The progress on reducing the non-performing loans portfolios and increasing provisioning is particularly noteworthy. Still, the recent Single Supervisory Mechanism's intervention in Banca Carige shows that some vulnerabilities remain, especially in the non-systemic banks. Continuing with the consolidation of smaller banks and a subsequent asset quality review of the newly created entities is warranted. Improved governance and risk management processes should be actively pursued by the supervisory authorities in parallel.

We are concerned by Box 3, detailing the systemic threat to financial stability stemming from the strong sovereign-bank nexus. We welcome the fact that the episodes of sharp widening of the sovereign spreads in 2018 have not yet resulted in a major tightening of the financial conditions for the real economy. In the longer term, however, banks will most likely be forced to pass the increased costs to their customers as their own funding is strongly correlated with the sovereign spread. In addition, banks will also face major funding rollover risks as the ECB's long-term financing operations mature in 2020 and 2021. We fully subscribe to one of staff's key messages that strengthening the sovereign balance sheet is a pre-requisite to financial sector stability. We also underscore that resolution frameworks should be utilized in a timely manner and appropriate burden sharing should be applied to limit the fiscal costs. Finding adequate bail-in-able instruments is particularly important in this context.

Higher economic growth which is sustained is key to reduce Italy's fiscal and financial vulnerabilities. Structural reforms are essential to improve Italy's competitiveness and lift the low potential growth. We understand the political economy constraints but note that repeated stimulation of the aggregate demand should not be a substitute for supply-side reforms but should complement them. We highlight the importance of decentralized wage bargaining, easing the barriers to entry for new businesses, and streamlining the regulatory, insolvency, and judicial frameworks. We are encouraged by the reforms adopted by the Italian government in January aimed at improving the bankruptcy and insolvency frameworks, as highlighted in Mr. Fanizza's statement. What is staff's assessment of these reforms? Finally, we note that governance changes are critical for the success of a broad range of structural reforms.

Mr. Beblawi and Mr. Al-Kohlany submitted the following statement:

We thank staff for their report and Mr. Fanizza for his informative buff statement. We broadly agree with the staff assessment and make the following comments for emphasis.

We welcome the outcome of the authorities' discussions with the European Commission (EC). The authorities' agreement to delay full implementation of some fiscal expansion measures in 2019 have lowered the deficit targets and mitigated the launch of the EC excessive deficit procedure. Nonetheless, we agree that the planned stimulus remains a source of substantial downside risks. Staff estimates that Italy's very high debt (above 130 percent of GDP) would rise over the medium term, due in part to higher pension spending, and that debt levels would rise even faster in the case of slower growth or rising spreads, compared with the base line.

In view of Italy's high public debt, we encourage the authorities to undertake a balanced consolidation of current spending, avoid reversal of pension reforms, and increase spending on well-targeted and high-multiplier items. Directing efficient spending toward public investment projects and targeting social benefits programs to liquidity-constrained households would help stimulate growth and alleviate poverty. To this end, we would welcome staff's updated assessment of the fiscal impact from the amended implementation of the "citizenship income" social spending program. Broadening the tax base, closing the large VAT compliance and policy gaps, and lowering the labor tax wedge are also important measures to enhance fiscal sustainability.

In the financial sector, we are reassured that the banks' overall liquidity position appears adequate and deposits are stable. Credit to the private sector grew, albeit modestly, and banks' asset quality improved notably. However, banks struggle with weak profitability and are vulnerable to the rising spreads and slowing growth. Elevated Sovereign spreads pose risks, especially for weaker banks, with respect to strains from increased funding pressures and falling asset values. As such, preserving financial stability and restoring market confidence in Italy's financial sector will require safeguarding Italy's public finances, as a first step. The authorities are also encouraged to double their efforts to strengthen the banking system resilience, including through reducing nonperforming loans, improving banks governance and profitability, and proceeding expeditiously with the plans to consolidate smaller banks.

The authorities acknowledge, as mentioned in Mr. Fanizza buff statement, that stronger and more durable growth requires a comprehensive package of structural reforms. To this end, we welcome their efforts to improve the labor market conditions and modernize the public administration and justice systems. Due considerations should be given to deepening competitiveness and wage bargaining reforms in order to better align wages with productivity. An important measure in this area is to decentralize the wage bargaining to replace the current system in which sectoral wage agreements are extended to the whole country. The recent adoption of a bankruptcy and insolvency framework could also help facilitate an efficient allocation of resources. However, it is not clear from the buff if the special insolvency regime for large enterprises—discussed in Staff Working Paper issued recently and the Staff Report—was folded into the adopted framework. Staff comments are welcome.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

Italy faces longstanding structural weaknesses that have contributed to low growth and weak social outcomes. At the same time, the very high level of public debt is a key source of vulnerability and limits space to lean heavily on fiscal policy to stimulate growth. In this context—and considering rising external headwinds—the authorities face the challenge of undertaking fundamental structural reforms to escape the low growth / high debt trap. We thank staff for a focused and impactful report and broadly agree with their analysis and policy recommendations. Specifically, we urge the authorities to put debt on a sustainable path by implementing a credible and growth-friendly fiscal consolidation, pursue decisive measures to improve labor market dynamics and boost productivity, and further reduce NPL overhang in the banking sector.

Fiscal policy: A credible fiscal consolidation is necessary to begin to reduce public debt, which at over 130 percent of GDP leaves Italy vulnerable to considerable external risks and rising funding costs. We welcome the agreement to lower the 2019 fiscal deficit target to avoid the launch of the excessive deficit procedure, which has already moderated funding pressures. However, the delay in planned measures and public investment only pushes difficult trade-offs down the road. While the authorities' planned stimulus could lift growth temporarily, rising funding costs from high debt and tighter global financial markets have the potential to counteract any growth benefit over the medium term. Plus, in the baseline scenario, the level of public debt would only plateau, assuming no further interest rate or growth shocks.

In this context, we agree with staff that a modest consolidation is warranted, combined with a shift in the composition of fiscal policy toward more growth-friendly and better-targeted spending. The recent easing of retirement rules was unfortunate in this regard. Could staff provide an estimate of the budgetary costs of the changes to the retirement rules and the adoption of the citizenship income program? Going forward, efforts to reduce tax loopholes and avoidance would be welcome. Further, increased public investment expenditures should be offset and subject to strong public investment management.

Structural: The authorities' growth strategy is primarily focused on stoking domestic demand and creating jobs through the citizenship income program and a rollback of pension system reforms. We share staff's view that the problems facing Italy are primarily structural in nature and not the result of insufficient demand. Thus, while we agree with the authorities' focus on improving social outcomes, we share staff's skepticism that the measures put forward will durably lower unemployment and raise productivity given the lack of attention to supply-side reforms needed to increase the demand for skilled labor. Further, we are concerned that the pension reform rollback could lead to lower labor participation and thus actually have an adverse effect on potential growth, in addition to its negative fiscal impact. We strongly urge the authorities to take under advisement the labor and product market measures articulated by staff, which we see as necessary to address the fundamental and long-standing barriers to stronger growth in Italy.

Per staff's simulation, a move to more decentralized wage bargaining could boost Italy's competitiveness and materially raise potential growth. We urge the authorities to further explore this reform, albeit recognizing the potential socio-political constraints to rapid implementation. The authorities note their view that the current system of two-tier bargaining sufficiently links wages with productivity given performance-linked bonuses. This view is hard to reconcile with staff's finding that a 30 percent labor unit cost gap has accumulated between Italy and the rest of the euro area over the past two decades.[2] Could staff shed more light on the divergence in views?

Financial sector: Italian banks have made welcome progress to address legacy bad debts and low profitability, but more progress is needed to shore up the sector as outlined by staff. Given the strong sovereign-bank nexus, financial sector stability ultimately hinges on stable public finances, further emphasizing the importance of fiscal and structural reforms highlighted above. Going forward, we urge the authorities to refrain from complex responses that shelter banks and investors from absorbing losses, and in the direction of the banking union framework where it is clear shareholders and unsecured creditors will internalize the cost for bank failures, rather than taxpayers. We also urge the finalization of the details of the Single Resolution Fund backstop and operationalization of a common euro area deposit insurance.

Mr. Mahlinza and Mr. Tivane submitted the following statement:

Italy continues to face considerable policy challenges relating to long-lasting structural weaknesses which are at the core of the low economic growth and poor social outcomes seen over the past several years. The commitment by the new Administration to take on these challenges through the implementation of a comprehensive reform agenda to support productivity growth, improve fiscal sustainability, strengthen financial sector resilience, and bolster social inclusion is a welcome development. While mindful of the politically-constrained environment facing policymakers, we encourage sustained efforts to rolling out the reform priorities needed to achieve durable macroeconomic and financial stability, and address social needs. We broadly concur with the policy priorities outlined by staff and thank Mr. Fanizza for his helpful buff statement.

Near-term growth is subject to sizable downside risks, underscoring the need to invigorate policies aimed at fostering economic resilience. A weaker growth outlook for the euro area, deteriorated terms of trade, and increased sovereign yields signal heightened downside risks for the Italian economy. Coupled with the high debt burden, crystallization of these risks

[2] Per IMF working paper 18/61

could weigh heavily on the country's ability to meet its sizable gross financing needs in the near term. Against this background, deploying a credible fiscal adjustment plan while simultaneously increasing fiscal space for growth-enhancing expenditure would help improving growth and resilience over the medium to long run.

Advancing growth friendly fiscal consolidation while preserving room for social inclusion policies is paramount to boosting economic recovery and safeguarding financial sector stability. In this respect, we welcome the adoption of the FY2019 budget law on December 30th, which ensures compliance with the European Union fiscal rules and entails a neutral fiscal stance. We are however, concerned, about the composition of the authorities' fiscal plan, which appears to be skewed to the expenditure side and could amplify debt vulnerabilities going forward. In this regard, we see merit in pursuing a more ambitious fiscal consolidation strategy to generate sustainable primary surpluses and place public debt on a downward trajectory over the medium run. Could staff comment on how the authorities' slightly higher growth assumptions for 2019-20 – as outlined in the buff statement – would impact the DSA projections under the baseline? We also encourage stepped up efforts to support revenue-enhancing measures to create space for development expenditures while addressing social priorities. In this regard, we would urge the authorities to consider specific measures to broaden the tax base, including addressing VAT compliance gaps, rationalizing tax expenditures and improving investment efficiency.

Buttressing financial sector stability is essential to support inclusive growth. Important progress has been made in easing financial-stability risks emanating from the sovereign-bank nexus and improving banks' capital buffers and underwriting standards. To further strengthen the banking system's resilience to shocks, including the sustained increase in sovereign spreads, we encourage the authorities to reinforce the supervisory oversight of non-performing loans (NPLs) disposal, improve liquidity buffers, enhance the crisis resolution framework, and closely monitor the consolidation of small banks.

Broadening structural reforms is essential to address long-standing competitiveness challenges. We are encouraged by the authorities' structural measures geared to address constraints to productivity growth through policies aimed at tackling labor market rigidities, improving the public administration and justice system. We also support measures designed to reduce temporary employment, support job search, and facilitate the labor force's skills acquisition to mitigate the impact of automation. In this regard, the authorities' plan to allocate, as part of the budget, 0.1 percent of GDP in additional resources to support these initiatives is welcome, but it should be consistent with achieving debt sustainability. Furthermore, stepped up efforts geared towards easing barriers to competition, cutting red tape, and simplifying procedures are essential to incentivize private sector investment, raise productivity, and bolster job creation.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for a well-focused set of reports and Mr. Fanizza for his helpful buff statement. We are in broad agreement with staff's analysis and policy recommendations and would limit our remarks to a few issues.

We welcome the authorities' objectives of fostering economic growth and social inclusion as well as preserving financial stability. This is indeed critical amid the challenges. In particular, real income per capita has fallen behind euro area peers and it is at the levels of two decades ago. Also, unemployment is elevated, especially in the south and among youth, while poverty has risen and the share of population at risk of poverty is high particularly among youth. Public debt remains high and a sizable fiscal expansion could trigger further debt sustainability concerns, especially if adverse shocks materialize. Growth has decelerated, and a further slowdown is expected in the medium-term in the absence of efforts to address remaining structural weaknesses. It is therefore important to improve economic and social outcomes while safeguarding financial stability including through the implementation of a gradual and growth-friendly fiscal consolidation, continued strengthening of banks' balance sheet, and implementation of the much-needed structural reforms.

While we welcome the authorities' structural reform efforts, we underscore the importance of sustaining these efforts especially in the context of improving productivity, competition, and the business environment. Here, we take positive note of the steps taken to improve the business environment and to stimulate private investment. Notably, we welcome the measures taken to improve the efficiency of the public administration, including the adoption of the anti-corruption law in December, as well as the overhaul of the bankruptcy and insolvency frameworks as noted in the buff statement. In addition, the introduction of active labor market policies to enhance, among others, job search is welcome, but we see merit in reducing the tax wedge to further improve not only productivity, but also domestic competition as rightly noted by staff. Here, we would appreciate staff's update on the authorities' plan to prepare a new competition law and on specific measures to address previous shortfalls. On a separate note, we invite the authorities to consider staff's recommendation on decentralizing wage bargaining to align wages with productivity at the firm level.

We encourage the authorities to pursue prudent fiscal policies to put public debt on a firm downward path to preserve fiscal sustainability. In this context, we welcome the lowering of the 2019 fiscal deficit target, as noted in the staff supplement. At the same time, we note that while Italy has successfully run primary fiscal surpluses for years, that did not seem to translate into lower debt ratio nor enhanced fiscal sustainability. Like staff, we consider that the priority is to pursue the right mix of fiscal policy composition, underpinned by growth and inclusive-enhancing measures, with a view to put debt in a downward trajectory. In addition, improving tax administration, broadening the tax base, while addressing VAT compliance gaps, could also help in this regard. We join staff in welcoming the authorities plan of gradual public investment increase to support growth. Nonetheless, this should be supported by measures aiming at improving efficiency of investment outlays including through strengthening public investment management. Also, social protection spending should be well-targeted to cover the most vulnerable segments of the society.

Finally, efforts to strengthen financial sector stability should continue to foster resilience and enable the sector to fully support the economy. This is important especially in the context of the elevated sovereign yields and its potential medium-term negative implication on economic activity and the financial sector even though high yield passthrough to the real economy has been limited thus far. Also, it is encouraging to note that the banking sector has proved resilient, supported by increased capital buffers and the continuous reduction of NPLs. The authorities' emphasis on continued improvement of the banking sector efficiency and profitability are welcome. We also concur with staff on the importance of consolidating small banks in a timely manner as well as dealing with weak banks.

With these remarks, we wish the authorities further success.

Mr. Ronicle and Miss Chen submitted the following statement:

We thank staff for an insightful report and helpful update. We also thank Mr. Fanizza for his informative buff statement. We associate ourselves with Mr. Meyer's statement and wish to underline a number of points for emphasis.

2017 saw faster growth than in preceding years, Italy has maintained current account and primary surpluses, banking sector balance sheets have improved and employment is rising. We note the authority's intention to tackle Italy's challenges, and recognise the difficulty in achieving political consensus. Nevertheless, we share staff concerns that the current reform strategy falls short of what is required to tackle Italy's fundamental challenge, low potential growth, especially given the relatively benign economic environment. That leaves Italy exposed to a number of risks, given its fiscal and financial vulnerabilities.

Structural reform

We were struck by the broad variation across central estimates of the output gap highlighted by staff. Are staff able to elaborate on the drivers of this variation?

Uncertainty over the output gap notwithstanding, Italy's potential growth has underperformed peers for some time. We welcome the authority's commitment to improving the business climate and raising investment. But we agree with staff that liberalizing product and services markets should be an important part of the solution to low productivity. Potential growth could be boosted further by raising labour participation, and we note the staff view in their update that the recent reversal of pension reforms and Citizens Income Programme may have the opposite effect.

Fiscal

We welcome the authorities' recognition of the need to reduce debt, through their revised budget, given the current level of public debt is a key vulnerability for the Italian economy. The market reaction observed in the last months is a good indication of the importance of a credible fiscal plan to address high public debt; a continued focus on ensuring sound public finances and rebuilding fiscal buffers is essential.

We read staff's debt sustainability analysis with interest. Staff's supplementary note says that the thrust of their conclusion remains unchanged, however it would be helpful if staff could elaborate further on the impact of the latest budget on the DSA, as well on the drivers behind the differences between this year and last year's debt sustainability analysis.

Banking sector

We agree with staff views on the banking sector and welcome the further reduction in NPLs. However the outstanding balance remains large and continued attention is required. In addition, addressing banking sector profitability is a key priority to ensure the sector's resilience in the face of future monetary policy normalization within the eurozone and recent stresses placed upon the sector.

We found the staff analysis on the impact of elevated sovereign spreads and their propagation to bank funding, lending costs and credit very interesting, and a timely piece of analysis. While staff note that there has been little pass through of elevated spreads to real economy lending rates to date, have they seen any other signs of credit tightening, for example in surveys of borrowers, collateral requirements or other quantity restrictions?

Mr. Doornbosch and Mr. Hanson submitted the following statement:

We thank staff for their insightful report and selected issues paper and Mr. Fanizza for his informative buff statement. Italy faces the challenge to increase potential growth and reduce the high level of public debt. This requires growth-friendly fiscal consolidation alongside structural reforms to support productivity and participation. We associate ourselves with Mr. Meyer's statement and would like to add the following comments for emphasis.

Debt reduction should be complemented with measures to improve the quality of public finance. Sizeable gross financing needs against the background of monetary normalization place a premium on swift debt reduction in accordance with the EU's Stability and Growth Pact. Staff argues that an increase in sovereign yields may offset the effect of fiscal expansions, but abstracts from these effects in its analysis. We doubt whether this is realistic, and we think growth-friendly fiscal adjustment will likely have positive short-term effects and will support potential growth. Furthermore, recent research suggests that the multiplier of public investment in Italy is not significantly different from zero.[3] In this light, we welcome the measures outlined in Mr. Fanizza's statement to increase the efficiency of public investment.

[3] De Jong, J., Ferdinandusse, M., Funda, J., Vetlov, I. (2017), "The effect of public investment in Europe: a model-based assessment", ECB Working Paper Series 2021.

Within-sector productivity differences call for measures to improve the business climate. Italy's low productivity growth is largely driven by productivity differences within sectors.[4] This requires measures to improve business dynamics. The actions to improve the efficiency of the public administration and the bankruptcy and insolvency reform mentioned in Mr. Fanizza's statement are steps in the right direction, but further measures are needed to improve judicial efficiency, strengthen governance and take away barriers to competition.

Measures to increase participation can reduce inequality and support potential output. In this context, we share staff's concerns about the reversal of the pension reform and the design of the citizenship income program.

Purchases of government bonds by the domestic financial sector reinforce the sovereign-bank link. The increased concentration of domestic sovereign bonds on the balance sheet of the Italian financial sector generates a vulnerability to fluctuations in sovereign yields. Staff writes that a rise in sovereign spreads has adversely impacted banks' capital and insurance companies' solvency ratios. This illustrates why changing the regulatory treatment of sovereign exposures is an important element of the agenda for financial sector reform.

Staff refers to "fiscal space at risk" versus "lack of fiscal space" in last year's report. Italy was categorized as "limited fiscal space" last year. In the current more granular categorization, "limited fiscal space" could translate into (1) "no fiscal space" or (2) "fiscal space at risk". The choice for the latter category is hard to reconcile with the reference to "lack of fiscal space" in last year's report and the Debt Sustainability Analysis. Could staff elaborate on the decision to choose for "fiscal space at risk" instead of "no fiscal space"?

Mr. Lopetegui and Mr. Di Tata submitted the following statement:

We thank the staff for the comprehensive report, the selected issues paper, and the supplementary information, and Mr. Fanizza for his informative buff statement.

Italy's main challenge is to address low growth and weak social outcomes. Although the growth rate for the last two years exceeded the average of the last decade, driven by accommodative monetary conditions, the

[4] See e.g. Pellegrino, B, and L Zingales (2017), "Diagnosing the Italian disease", NBER Working Paper no. w23964.

staff's supplement envisages a deceleration over the medium term, with potential growth estimated at only 0.6 percent. This is clearly too low to meet the country's challenges of relatively high unemployment, a high proportion of households at risk of poverty, and large income disparities across regions. The authorities are now projecting real GDP growth at a somewhat higher rate of about 1 percent a year in 2019-2021. Could staff elaborate on the main differences behind the staff's growth projections and those of the authorities?

We concur with staff that addressing Italy's low growth performance requires a significant strengthening of the structural reform content of the authorities' strategy. We welcome the new government' emphasis on fostering growth and social inclusion. As noted in Mr. Fanizza's statement, the authorities recognize that increasing growth on a sustained basis requires a comprehensive package of structural reforms. However, the feasibility of adopting such package is constrained by political considerations, and the new coalition government has decided to focus on a limited set of agreed measures.

A stronger fiscal effort is also needed to reduce the government's large gross financing needs and to put the high public debt-to-GDP ratio on a firm downward path. Although Italy has maintained primary fiscal surpluses for several years, those surpluses have been insufficient to address its high debt burden. As noted by staff, elevated sovereign spreads could weigh further on growth, given Italy's sizable gross financing needs (above 20 percent of GDP). Sustained high spreads also risk passing through to borrowing costs of firms and households, raising concerns about financial stability. More generally, avoiding a heightened stress scenario is of critical importance, given possible significant global and regional spillovers, particularly within the euro area. Could staff elaborate on the possible implications of the end of the ECB's net purchase program of public debt?

Structural reforms to boost productivity growth, including labor and product market reforms, should play a key role to achieve higher durable growth. Decentralizing wage bargaining to facilitate a re-alignment of wages with productivity at the firm and regional levels would have a positive impact on structural unemployment, while lowering the costs of dismissal would encourage hiring. The political feasibility of these reforms and of introducing a minimum wage differentiated by regions, however, seems to be low. In this regard, could staff elaborate on the regional differences in productivity, unemployment rates, and informality between the north and the south? The staff report also indicates that the authorities are interested in preparing a new competition law. Is the new legislation likely to address the existing regulatory impediments and barriers to competition?

On other structural issues, we welcome the measures under way to improve the business climate, including the anti-corruption law adopted in December, the ongoing efforts to speed up civil justice, the reform to overhaul bankruptcy and insolvency procedures, and the actions under way to improve the efficiency of the public administration. Going forward, decisive efforts will be needed to ensure the effectiveness of these reforms by improving managerial and administrative capacity. Moreover, the special insolvency regime for large enterprises should be addressed in the context of the reform to modernize the insolvency framework.

We concur with staff on the need to pursue a credible medium-term fiscal consolidation accompanied by improvements in the quality of policies to safeguard macroeconomic stability and promote inclusive growth. While we welcome the authorities' efforts to contain the fiscal deficit for 2019 within 2 percent of GDP to ensure compliance with the EU fiscal rules, the supplement issued by staff notes that this would be achieved in part by delaying the implementation of some policies, and that the fiscal deficit would increase to 3 percent of GDP in 2020-21. In contrast, the authorities' revised targets for 2020 and 2021 are 1.8 percent of GDP and 1.5 percent of GDP, respectively, as their projections include the impact of sizable VAT and excise tax rate hikes that are not incorporated in the staff's projections "in view of their poor implementation history". Could staff elaborate further on the reasons behind this difference between the two projections?

There is room to improve the composition of public spending and reduce distortions. We welcome the authorities' plans to gradually increase public investment and ensure its efficiency. To help spur employment, we would advise a reform of the tax system to broaden the tax base and lower the tax wedge on labor. The authorities should also ensure the viability of the pension system and limit the cost of the recent reversal of past pension reforms that has eased retirement rules. We also encourage the authorities to establish adequate controls to effectively target the new poverty relief program that will become operational in April 2019.

We are encouraged by the significant progress made in recent years in improving the health of the banking system, which has led to a reduction in problem assets, strengthened capital levels, and a gradual improvement in profitability. Efforts should continue to restore the resilience of the system, including through close supervision of NPL reduction strategies, prompt implementation of the envisaged consolidation of cooperative banks into three banking groups subject to asset quality reviews, further progress in strengthening governance, and the swift recapitalization or timely use of the resolution framework for problem banks. On a related matter, could staff elaborate further on the appropriateness of the strategy being implemented to deal with Banca Carige? Links between the sovereign and the financial system should be monitored closely, given banks and insurance companies' large holdings of government securities.

With these comments, we wish the Italian authorities every success in their future endeavors.

Mr. Johnston, Ms. Preston and Ms. Park submitted the following statement:

We thank Mr. Fanizza for his helpful buff statement. Italian authorities have inherited a challenging economic and social environment including no growth in per capita real incomes in two decades, an erosion of living standards amid double digit unemployment and increasing levels of poverty. High levels of public debt are raising sustainability concerns. The situation is further complicated by two political parties being partners in government and needing to focus on areas where they can find agreement. Italy is at a difficult crossroads, where making difficult choices now may mean that there are more and better policy choices to be made later.

Importantly staff and authorities agree on the objective of improving social and economic outcomes in Italy. Where there is less agreement is on the appropriate set of policies needed to achieve this. We share staff's view that pursing the current path has significant risks and leaves Italy exposed to vulnerabilities that have the potential to undermine the very objectives authorities are seeking to achieve—namely to foster growth and social inclusion while preserving financial stability. While we welcome the recent adjustment to fiscal policy that now ensures Italy's compliance with EU fiscal rules, we share staff concerns about the quality of this adjustment, noting that although the deficit target for 2019 is lower through delays in implementation of planned policy, there is no fundamental improvement in policies. A forced fiscal contraction, potentially pushing the economy into a recession, would disproportionally push the burden of adjustment on those that are most vulnerable.

We welcome staff's evaluation of the authorities' proposals, with a clear assessment of the economic and social risks associated with this path of action. Staff also observe that numerous structural reform efforts have been undertaken in the past but none were comprehensive or sustained. We note staff's concerns that the authorities' strategy could fall short and could leave Italy vulnerable. We note staff's recommended set of reforms and wonder if staff could gain further traction with the authorities by providing more granular advice on how authorities might go about these reforms, in the Italian context. In particular, how might the authorities go about progressing reforms to decentralize wage bargaining within the current political climate? Did staff consider also the impact on inclusive growth of introducing minimum wages by region and has such a regional approach been tried elsewhere? What are the lessons learnt from past experience with structural reforms in Italy and have these been factored into staff's advice to the authorities?

We appreciated the innovative presentation of the risks and transmission channels in the Risk Assessment Matrix, particularly to clearly draw out sovereign-bank linkages. In addition, risks to the global economy associated with a no-deal Brexit were highlighted in the recent January WEO update. We would appreciate staff's advice on the potential macro-financial spillovers of such a Brexit outcome as they might apply to Italy.

Finally, closer integration of the Italian economy into the global trading system has undoubtedly delivered significant benefits. Domestic policy settings are crucial mitigating the adverse impacts of globalization and to regaining the trust of populations in the benefits of trade. Domestic policies play significant role in helping individuals and communities adjust to trade-induced structural shifts in the economy and are necessary to share the benefits of higher growth.

Mr. Palei submitted the following statement:

We thank staff for their papers on Italy and Mr. Fanizza for the informative BUFF statement. Since June of last year, a new government has formulated its reform agenda aimed at improving economic growth and making it more inclusive. According to staff the authorities' plans are not likely to achieve the announced objectives. In their report, staff insist on cutting the pension benefits and streamlining the broader welfare system in Italy. In addition, staff view liberalization of the labor and product markets as a matter of highest priority in Italy. In our opinion, the differences in views between the authorities and staff are somewhat exaggerated in the report. We believe that highlighting positive aspects of the ongoing changes in Italy and focusing on proposals in line with the authorities' reform agenda may gain more traction in surveillance going forward.

We believe that staff should support more enthusiastically the authorities' efforts to improve governance and reduce corruption in Italy. According to staff, the Italian authorities intend to build upon several legislative reform initiatives and are now focused on reducing public sector inefficiencies and tackling corruption (paragraphs 26 and 27). Mr. Fanizza in his statement highlighted the reforms of the civil justice and the reorganization of courts and strengthened this message with his reference to an anti-corruption law adopted in December. According to previous studies at the IMF, successful reforms in this area are likely to offer substantial growth dividends[5]. Based on these quantitative estimates, can staff, first, elaborate on the likely growth effects from improvements in the quality of governance in Italy? Second, we would like staff to apply to Italy another approach recently used for many IMF members. What would be the growth effects in Italy if the authorities were able to move from the country's current 54th place in the Corruption Perception Index ranking to the average of other G-7 members, which is close to the 14th place?

We believe that the Italian authorities are on the right track focusing their immediate efforts on improvements in public sector efficiency. Their efforts to cut red tape and simplify certain procedures appear to be consistent with the objectives of the authorities in many other countries, which successfully linked their efforts to the improvements of the Ease of Doing Business ranking. We encourage the Italian authorities to embrace a similar well-defined strategy supported by close engagement with the World Bank.

Italy is already one of the few countries with regional rankings in the Doing Business. In addition, according to the World Bank, Italy, together with Ireland and Greece, is one of the pioneers participating in the Doing Business in the European Union project sponsored by the European Commission's Directorate-General for Regional and Urban Policy (DG REGIO). Taking into account the Italian authorities' efforts to collaborate with the Doing Business project and even leading the EU efforts in this area, we would like staff to clarify the authorities' position mentioned in paragraph 29.

Fiscal policy is another challenge for the Italian authorities. We appreciate the authorities' arguments about the need to focus on pressing social issues. Under the current political circumstances, it may be difficult to put an emphasis on the expenditure side of the fiscal policy. Fortunately, according to staff's analysis, there is substantial room to reduce deficit

---

[5] Is the public sector holding back Italy's productivity? Giordano, R. et all (2015); available at https://voxeu.org/article/public-sector-inefficiency-and-firm-productivity-italy

through the reforms on the revenue side[6]. We believe that such an approach would be consistent with the announced drive toward better governance. We see room for close cooperation with the Fund in this area. As a related matter, we would be interested to know whether staff and the authorities discussed the benefits of conducting a fiscal transparency evaluation, as it was done in several other advanced European economies, including the U.K., Austria, Portugal, Finland, and Ireland?

Tax expenditures in Italy are estimated at 5.5-6.5 percent of GDP. Italy also has the weakest performing VAT system in the EU, with the VAT C-efficiency at about 40 percent. Addressing compliance and policy gaps will allow the authorities to increase fiscal revenues by about 1 percent of GDP. Additional improvements in the property taxes may add another 0.5 percent of GDP. Overall, we see similarities between the authorities' current policy agenda and the Fund's proposals on the revenue side. Staff comments on the feasibility of initial emphasis on the revenue side of fiscal reforms would be appreciated.

In their evaluation of risks to the economic outlook in Italy staff emphasized the role of the fiscal consolidation, debt dynamics, and possible negative confidence effects on the country's risk premium. In this respect, we would like to better understand the role of the denomination risk, not just the fiscal policy risks. For example, Daniel Gros attributed about half of the widening in spreads on the Italian government bonds to denomination risks[7]. Do staff agree with the prominent role of these effects, in addition to fiscal risks? We support staff's call for an in-depth and timely analysis of spillovers from Italy, as last May the contagion did affect Portugal, Spain, and other economies.

Finally, we would have preferred to see more analysis in the Article IV report and the Selected Issues paper, not the references to the IMF Working Papers. In this regard, does the Board discussion on Italy change the status of the Working Papers making them an opinion of the Board and the Fund, not just that of staff?

With these remarks, we wish the Italian authorities success in facing challenges ahead.

[6] Italy: Toward a Growth-Friendly Fiscal Reform, IMF Working Paper, WP/18/59

[7] Italian Risk Spreads: Fiscal versus Redenomination Risk. Gros, D., available at https://voxeu.org/article/italian-risk-spreads-fiscal-versus-redenomination-risk

Mr. Raghani, Mr. Razafindramanana and Mrs. Boukpessi submitted the following statement:

We thank staff for their comprehensive report and selected issues paper as well as Mr. Fanizza for his informative buff statement.

We welcome the Italian authorities' policy to boost growth and address social inclusion issues stemming from the economic recession experienced over the past years. Despite progress made thus far, the economy is still facing daunting challenges including high public debt, persistent vulnerabilities in the financial sector, structural rigidities in the labor market and low investment and productivity. In this context, we encourage the authorities to steadfastly implement the needed measures to reduce public debt and far-reaching structural reforms to foster higher growth, increase productivity, enhance competitiveness and strengthen financial stability. Moreover, efforts should be stepped up towards unleashing Italy's potential growth, enhancing its resilience to shocks and further improving socio-economic indicators.

We broadly share the staff assessment and would like to offer the following comments:

On fiscal policy, we agree that a sound fiscal consolidation strategy is key to create the needed fiscal space to increase investment, improve social outcomes and resolutely put the high public debt-to GDP ratio on a downward path. Italy's public debt is high at about 131 percent of GDP and is likely to rise in the context of monetary conditions normalization.

We encourage the authorities to implement their consolidation strategy to ensure that the debt-to GDP ratio will start declining as envisaged in 2019. In doing so, attention should be paid to growth-friendly and inclusive measures. We agree with staff that efforts could put emphasis on broadening the tax base by reducing VAT compliance gaps and lowering labor tax wedge. Moreover, reducing current expenditures will be necessary to create room for higher public investment and social spending. As for the latter, it will be critical to strike the appropriate balance between rationalizing the pension system and improving safety net for the vulnerable groups. While taking note of the authorities' citizenship income program, we would like staff to further elaborate on this measure and its expected effects.

As regards the financial sector, we commend the authorities for their continued efforts to safeguard the sector stability. We take note of the overall health of the banking system demonstrated by improved asset quality and capital ratios of significant banks as well as adequate liquidity. However, increased efforts are required to address remaining key vulnerabilities including the high stock of NPLs and weak profitability. In addition, further steps to improve the efficiency of the resolution and supervisory frameworks are key to ensure that bank groups' business models are viable and profitable. As such, enhancing governance, strengthening weak banks and consolidating smaller banks should remain high in the authorities' priorities. Finally, in view of the recent rise in sovereign yields and the increase in tail risks that would negatively affect the banking system, we support the call for the steadfast implementation of EU regulations notably the Minimum Requirements for own funds and Eligible Liabilities (MREL) and the Markets in Financial Instruments Directive (MiFID).

Far-reaching structural reforms are critical to address the impediments to high and sustained growth. Over the past years, the authorities have made good progress in advancing structural reforms and reducing imbalances, including through the 2018 Dignity Decree. However, further efforts will be necessary to boost public investment, improve the business environment and enhance the functioning of the job market. Despite some recent improvements, there is a need to increase labor force participation to European peers' level and forcefully address the long-term youth unemployment. Along with active labor market policies, we encourage the authorities to press ahead with the reform of the wage bargaining system to better align wages and productivity across firms and regions. Additionally, efforts to liberalize product and service markets will stimulate competition and investment. Finally, we welcome the initiatives in reforming the public administration over the implementation of effective actions to address corruption, cut red tape, simplify administrative procedures and reform state-owned enterprises. We are pleased to note from Mr. Fanizza's buff statement that a reform of the bankruptcy and insolvency frameworks has been adopted this month. Similar progress would be warranted in the civil justice system.

With these comments, we wish the Italian authorities every success in their future endeavors.

Mr. Inderbinen, Mr. Trabinski and Mr. Tola submitted the following statement:

We thank staff for the candid report and the clear policy recommendations, and we are grateful to Mr. Fanizza for his helpful buff. We note the differences between staff and the authorities in the assessment of the impact of fiscal stimulus on growth, the dynamics of public debt, and the prospects for broader structural reforms.

The implementation of a growth-friendly fiscal consolidation strategy is crucial to putting public debt on a downward trajectory. Italy's debt stock remains among the highest in the euro area and makes the country vulnerable to shocks and changes in market risk perception. Given the sizeable sovereign-bank nexus, public debt vulnerabilities can also affect financial sector stability. It is encouraging that the adopted 2019 budget complies with the EU Excessive Debt Procedure and aims at lowering the debt-to-GDP ratio, as indicated by Mr. Fanizza in his Gray. Nevertheless, the envisaged budget deficit in 2019 could further deteriorate even in case of a modest shock to the economy. Moreover, the DSA shows that public debt is also vulnerable to negative shocks to growth, the primary balance, and an increase in real interest rates. All these factors point to the importance of reducing public debt and consolidating the fiscal accounts while external conditions are benign, and growth remains above potential.

The implementation of long-delayed comprehensive structural reforms is key to unlocking Italy's growth potential. We commend the authorities for their efforts aimed at addressing some long-standing structural weaknesses. Nevertheless, we agree with staff that to achieve sustained improvement, it would be necessary to enhance potential growth. The authorities should take advantage of the mature phase of the on-going recovery in the euro area and the accommodative monetary policy to push forward with structural reforms. Further progress is needed in taxation, the judiciary, labor and product markets, and fighting corruption. The successful implementation of structural reforms would lift potential growth, enhance Italy's resilience to shocks and reduce the risk premia on Italian bonds. This, in turn, would create the necessary fiscal space for investment and social spending.

While we support the authorities' efforts to promote growth and social inclusion, we believe that the achievement of these goals would be better served by a sustainable fiscal stance. The effectiveness of new budgetary measures in stimulating the economy will largely depend on the preservation of financial markets' confidence in Italy's fiscal sustainability. The authorities run the risk that the negative impact of larger sovereign spreads—either through higher interest spending or higher borrowing costs for the private sector—will outweigh the impact of fiscal expansion. Increasing public investment should give a boost to the supply side, provided that the efficiency of investment spending is improved. We welcome the introduction of a minimum guaranteed income scheme for the poor, but we encourage the authorities to calibrate it in such a way to avoid unwanted adverse effects on employment. Staff's selected issues paper provides some useful suggestions in this regard.

Decisive efforts to advance labor market reforms would be necessary to raise productivity. Structural unemployment remains elevated, and labor force participation continues to be low. Therefore, a strong emphasis is needed on labor market reforms. As highlighted in the report, measures could include wage bargaining reforms aimed at aligning wages with productivity, as well as steps to address regional disparities and skill mismatches. Higher labor market flexibility and lower dismissal costs would be essential to encourage hiring and thus raise labor market participation. In this context, we regret the reversal of key elements of the 2015 Job Act.

Further efforts are necessary to address the vulnerabilities in the banking sector. The improvement of banks' asset quality as well as the increased profitability of banks is encouraging. We also note the reduction in non-performing loans over the past year; nonetheless, the volume remains among the highest in Europe. We share the view that an accelerated repair of bank balance sheets is essential to enhance banks' resilience and strengthen financial stability, also with a view to the potential funding challenges linked to the phasing out of the TLTRO. Close supervisory oversight over NPL reduction strategies should be maintained and the consolidation of cooperative banks should be advanced. The recent intervention of the ECB in Banca Carige has reduced near-term risks, but the case underlines the ongoing concerns of financial sector stability in Italy. Could staff elaborate on the next steps the authorities intend to take in the case of Banca Carige?

Mr. Kaizuka and Mr. Minoura submitted the following statement:

We thank the staff for the comprehensive reports and Mr. Fanizza for his informative statement. It is welcome that the Italian authorities lowered the fiscal deficit targets and avoid the launch of an excessive deficit procedure through discussions with the European Commission (EC). However, Italy continues to face significant challenges and vulnerabilities, including stagnant productivity growth and high levels of nonperforming loans (NPLs) and public debt. Against this background, we concur with staff that a package of structural reforms, a credible fiscal consolidation and bank balance sheet strengthening are the only durable ways for Italy to improve outcomes and enhance resilience. As we agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

As the public debt remains very high at above 130 percent of GDP and its vulnerabilities to adverse shocks, credible fiscal consolidation is indispensable. We take note of staff's projection that the deficit is to rise from about 2.1 percent of GDP in 2019 to 3 percent of GDP in 2020 and beyond, unless there is broad political support to activate the VAT safeguard clause or find compensatory measures, which however have proven difficult to do in the past. Could staff share details on requirements for activation of the safeguard clause and the past experiences? Against this background, we support consolidation measures recommended by staff, underpinned by a shift in the composition of policies to promote growth and social inclusion. In this light, pension reform reversals should be avoided. We share staff's concern that reduction of the effective retirement age will increase spending further, impose even more burdens on younger generations, leave less room for pro-growth policies, and lower employment rates among older workers. Instead, a modern, guaranteed minimum income scheme targeted to the poor should be sought. At the same time, it is also essential to reduce current spending, broaden the tax base and lower the tax wedge on labor while preserving public investment. With regard to a comprehensive reform of tax system which staff advocates, what are the expected contribution of the reform in improving the country's fiscal position both by policy reform and that of tax administration?

Structural Reform

We encourage the authorities' further efforts on labor and product market reforms, which are indispensable to tackle Italy's structural rigidities and boost potential growth. Given Italy's high structural unemployment and ULC-gap, we agree with staff's recommendation of decentralizing wage bargaining as a reform of first-order importance, to facilitate re-alignment of wages with productivity at the firm and regional levels. As Italy's labor force participation is the lowest among euro area countries, well-designed reductions in the tax wedge on secondary earners should be pursued.

At the same time, promoting competition and improving the business environment critically important for raising productivity. In particular, public sector inefficiencies, a slow justice system and an inefficient insolvency framework need to be given top priorities. Regarding the firm level total factor productivity (TFP), it is surprising that TFP has declined even among firms on the technological frontier, as it is different from the global trend suggested by existing researches (e.g. Andrews, Criscuolo and Gal (2015)). We would appreciate staff's explanation on factors behind Italy's firm level TFP trend.

Financial Sector

While it is encouraging that banks' asset quality has improved notably over the past year, Italian financial sector continues to face significant challenges including high NPL ratio and low profitability. Intensive supervisory oversight of NPL reduction should continue in the banks supervised directly by the SSM, and it should be extended fully to smaller banks with high NPLs. Noting that SSM's thematic review identified no systemic issues for Italian banks but rather found considerable opportunities for individual banks to improve their business models and processes, we invite staff to elaborate more on the SSM's review and share staff's view on their recommendations.

Moreover, the consolidation of smaller banks should be implemented swiftly, to help address lingering concerns over the health and viability of the smaller banks. It is also important to ensure robust governance, sound risk management, and viable business models through ambitious and credible targets. Dealing with weak banks, including the importance of building MREL buffers, remains a significant challenge. We concur with staff that swift recapitalization of problem banks or the timely and effective use of the resolution framework is essential to avoid weaknesses from lingering, excessively burdening taxpayers and the rest of the system, and threatening stability. At the same time, we underscore that a pre-requisite to financial sector stability is safeguarding the public finances.

Mr. Jin and Mr. Huang submitted the following statement:

We thank staff for the set of papers and Mr. Fanizza for the useful buff statement. While the authorities chose a fiscal stimulus and focused on urgent issues, a comprehensive supply-side structural reform is essential to achieve strong and sustainable growth. We agree with the thrust of the staff's appraisal and would limit our comments to the following.

It is encouraging to see that the authorities and the European Commission reached a consensus on the lowered budget deficit targets. The inherited high-public debt limits fiscal policy space, so we encourage the authorities to continue their efforts to rebuild the fiscal buffer. We note with concern that a large amount of Italian public debt was purchased under the framework of ECB's net asset purchase program. As the program comes to an end, this part of annual gross financing needs would be fulfilled by the market. Can staff elaborate on how this would impact both Italy's public financing and financial markets' stability?

We commend the authorities' efforts to strengthen the banks' balance sheets. Banks have strengthened their capital base and improved their credit quality since the crisis. However, with the historical burden of outstanding NPLs and weak banks, further action is needed to make the banking sector more resilient. The sovereign-bank link deserves more attention. The purchase of government security by the Italian financial sector makes it vulnerable to the potential hike of sovereign yield. Can staff provide some policy suggestions, including macroprudential tools to moderate this sovereign-bank link?

A well-designed social welfare system could help to make the labor market more flexible, while protecting the most vulnerable groups. We see merit in the measures recommended by staff on the pension reforms. Too generous pension benefits might not only discourage businesses to hire formally, but also crowd out resources for the more vulnerable people. We also share staff's view on early retirement. While it is doubtful that early retirement could release many jobs for the youth, it is highly likely that it would further burden the working-age population and endanger fiscal sustainability. In this regard, we agree with the staff on the reforms on the social welfare system, in particular pension benefits.

Mr. Mojarrad and Mr. Sassanpour submitted the following statement:

We thank staff for a well-written and concise set of papers and Mr. Fanizza for his insightful buff statement. We agree with the thrust of the staff report and believe that staff's well-balanced recommendations rightly focus on key issues going forward. Structural weaknesses and an uneven policy approach, along with slowing economic activity in the EU, have been reflected in an anemic growth and high unemployment in Italy, with the youth and disadvantaged carrying most of the burden. At the same time, elevated public debt and sovereign spreads are giving rise to debt sustainability concerns, with potentially significant spillover implications, at the time when global financial conditions are hardening and trade conflicts are mounting.

Italy's high public debt remains its main source of vulnerability as modest primary surpluses of the past few years have only managed to stabilize the debt ratio without allaying market concerns. What is needed is a credible, high-quality and sufficiently tight fiscal stance—sustained over the medium term—to put the debt ratio on a firm downward path, rebuild investor confidence and, at the same time, address the longer run social issues through an appropriate mix of measures. In our view, the balanced menu of budgetary measures proposed by staff merits serious consideration. The new government's focus on raising growth and improving social outcomes are all well placed, but we agree with staff that the major fiscal stimulus planned for 2019 is likely to provide only a short-term respite, while adding to debt and heightening vulnerabilities. Fiscal policy also has an important role to play in balancing the income distribution that has long been skewed against the youth and vulnerable. Welcoming the authorities' plans to increase social inclusion, we urge them to formulate policies within an all-encompassing framework that brings together the various income support schemes, while avoiding welfare traps and work disincentives.

Growth and employment underperformance in Italy is more of a structural nature, and correcting it requires broad and sustained structural reforms in a number of areas, particularly in the labor and products market. Alleviating labor market rigidities pays a high dividend in the longer run and should have a high priority. Aligning wages with productivity, reducing the tax wedge on labor, increasing wage-setting flexibility reducing dismissal costs are all elements of a comprehensive labor market reform strategy. Productivity would also benefit from greater competition in the products market. We encourage the authorities to seriously consider easing regulatory impediments and barriers in the context of the new competition law under deliberation. SOE reform, strengthening efficiency of public administration, and reducing red tape are other elements of a more efficient products market that is more attractive for investment and doing business. In this regard, we welcome the recent adoption of a new bankruptcy and insolvency regime, as indicated by Mr. Fanizza.

The high and rising spreads increase costs for all banks, especially those with large sovereign exposure, and pose serious challenges for weaker banks. We commend the authorities' successful efforts to lower NPLs and welcome their plans to consolidate cooperative banks. The problem banks should be dealt with in a timely manner through recapitalization or resolution.

In view of the significant downward risks in the financial sector, sustained efforts should be made on all fronts to continue to strengthen banks' balance sheets and build resilience in support of real activity.

We wish the authorities success in meeting the challenges ahead.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their informative and balanced report and Mr. Fanizza for his informative buff statement. The review of the Italian economy intervenes in a rapidly changing environment and January's WEO projections for Italy's GDP have been revised downward for 2019 and 2020 respectively. Additionally, a revised budget for 2019 has been approved in December 2018. We acknowledge this positive step forward which has already translated into a decline in sovereign spreads even though they remain high. A continuous decline of interest rates is needed to contain the rising cost of public debt. Beyond this risk, we see the development of a comprehensive structural reforms strategy as a priority in a context of low growth and high public debt, and therefore strongly support staff's recommendations in this regard, including on labor, product and service markets and pensions. We also share staff's analysis that consolidating the fiscal accounts in a gradual and growth-friendly manner while external conditions are still favorable is warranted. While we salute the willingness of the authorities to make growth more inclusive, this should be done in a way ensuring tax fairness and public finance sustainability. Moreover, we see the need for fiscal policy to be rebalanced towards more intergenerational equity. We associate ourselves with Mr. Meyer's statement and wish to make the following remarks.

Outlook and risks

We agree that risks for the Italian economy have tilted to the downside in a context of economic deceleration of the Euro area, deterioration of terms of trade and tightening financing conditions. Low productivity and suboptimal tax composition have been hampering Italy's growth and competitiveness over the past years. Nonetheless, as recalled by Mr Fanizza in his buff statement, the private debt remains relatively low, the external position is resilient with a current account surplus and the banking sector is gradually strengthening.

Against this background, we share staff's assessment that fiscal consolidation should be gradual, credible and growth-friendly. Growth is expected to keep slowing down in the coming years, but the new public deficit targets set as part of the agreement between the authorities and the European Commission (2,0 percent of GDP in 2019) would contribute to stabilize public debt. The consolidation package of about an annual 0,5 percentage point during 2019-2023 based on higher revenues and lower spending (mainly current expenditure) would help to maintain public debt on a downward path. Given that impediment to growth and job creations are mainly of structural nature, one can doubt whether additional fiscal easing would be efficient to promote growth on the medium or long run. Given the high level of public finance indebtedness and its high sensitivity to interest rate levels and growth shocks, there is a risk that the net effect of the fiscal stimulus might be limited due to markets reactions and higher interest rates.

Structural reforms

Pro-growth structural reforms are the key to raise Italy’s productivity and social inclusion. We fully align ourselves with staff’s recommendations on the criticality of improving labor market outcomes for the most vulnerable categories of population, including the young and the unemployed. We also see the merit of an enhanced decentralization of the wage bargaining system at the firm level in order to better re-align wage growth with productivity growth while monitoring the impact on structural unemployment. Promoting competition should also remain on top of the priorities of structural reform. The approval of the Annual Competition Law is a positive step and we encourage the authorities to proceed further in this direction in line with the strengthening of the Competition Authority. Services sectors such as local services, professions and retail would benefit from further liberalization by boosting productivity and lowering costs for customers. We also take note of the willingness of the authorities to plan advancing initiatives in public sector reform as more progress is warranted to improve the business environment, fight corruption, rationalize procurement and make public contracts more transparent. Going ahead, prudence should remain the watchword when it comes to consider reversing some of the key benefits of past reforms such as the Jobs Act or the 2011 pension reform (with the reduction of the effective retirement age). For the latter and based on cross-countries evidence, the positive economic fallouts could be offset by higher burdens on younger generations and lower-than-expected job creations, as stressed in staff’s report.

Social inclusion

We fully support staff’s assessment on poverty and concur with the recommendations made in the dedicated selected issues paper aiming to ensure that the guaranteed minimum income scheme is effective to fight poverty and financially sustainable. In addition to adequate policy to fight informality, the citizenship income program could target higher benefit levels without creating distortions and broader base of beneficiaries while introducing in-work benefits, gradual phase-outs to incentivize job research and controls to prevent abuse. Broadening the tax base and lowering tax rates on productive factors are also a key component of more growth-friendly and inclusive policies. In that sense, we concur with staff that the tax reform should address tax compliance and namely large VAT compliance gap, rationalize expenditures and alleviate the tax burden on work. These considerations should be consistent with the consolidation path while preserving progressivity and reducing fraud and tax evasion.

Banking sector

Progress has been made in the strengthening of the banking sector and should be continued to further enhance resilience of the financial sector. In particular, the rate of NPL is on a clear downward trajectory and the banking sector is submitted to enhanced supervision while being better capitalized. We note that the increase of sovereign spreads has not yet translated into an increase in the cost of capital and the strength of the transmission channels from sovereign to bank funding and to the real economy should be carefully considered. Going forward, we concur with staff that close supervisory oversight of NPL reduction strategies should be maintained and that consolidation of cooperative banks into three new banking groups should be pursued. Finally, more emphasis should be put on abiding by the European resolution framework.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their Report and Issues Papers and Mr. Fanizza for his buff Statement. We associate ourselves with the statement by Mr. Meyer and would like to further highlight a few issues.

We broadly concur with Staff's assessment of deteriorating growth prospects and the need to address existing imbalances and vulnerabilities to restore confidence. Given Italy's very high public debt, uncertainties about the net effect of the fiscal stance following the revised Italian budget approved in December, elevated financial market volatility linked to debt sustainability concerns and high policy uncertainty are starting to weigh on domestic demand. Given an external environment which is any case characterized by increasing headwinds, weaker domestic demand can further suppress growth and increase the risk of a recession. Recent weak data releases attest to worsening near-term growth outlook.

The net economic effect of the budgetary measures is surrounded by a significant degree of uncertainty. An accurate assessment of the effect of the revised Italian budget is difficult at this stage in the absence of implementing decrees. Furthermore, the net positive effect of the expansionary budget measures on domestic demand depends on the extent to which these are offset by increased funding costs for the economy. This would happen if increased sovereign yields transmit to financial sector funding costs and eventually lead to deteriorating financing conditions for households and firms. So far, there are no strong signs of pass-through to the economy at large. This is in large part a reflection of the fact that the Italian banking sector has a comfortable liquidity position, including the use of TLTROs.

We support Staff's recommendation to pursue a gradual fiscal consolidation with a view to achieve a small structural surplus over the medium term. Despite the lower than initially expected fiscal loosening in 2019 decided in December, projected higher interest payments resulting from the recent increase in sovereign bond yields already now almost offset any additional primary spending. The agreement with the Commission on a more ambitious fiscal target somewhat mitigates these risks but does not alter the overall assessment. Therefore, a reduction in the debt-to-GDP ratio through prudent fiscal management and improving potential growth is essential to dispel concerns about debt sustainability that in turn weigh on confidence and economic outcomes. We broadly concur with a consolidation pace of 0.5 percent of GDP per annum over the five years 2019-23, which is broadly consistent with the requirements of the SGP's preventive arm.

We also concur with Staff that the quality of public finances could be improved. The tax incidence is strongly skewed towards labor and applied on a relatively narrow base due to generous deductions and credits. The social system favors pensioners over other vulnerable groups (children and working-age population) and remains fragmented and complex. At the same time, public investment remains low. The fiscal strategy should be growth-friendly, including rebalancing to less distortionary taxes and growth-oriented expenditure. There is room to improve Italy's social and tax systems through modernizing the safety net and lowering tax wedges on labor. The latter includes broadening the tax base via reducing tax expenditure or reforming outdated cadastral values.

Important progress made in increasing the resilience of the banking system should be continued. The reduction in NPLs achieved so far is substantial, thanks to both large NPL sale transactions and lower new NPL inflows. However, the current stock of NPLs remains high as a ratio of total loans (9.7 percent) compared to a euro area average (of 4.4 percent). The remaining high NPL stock and weak bank profitability continue to be the main challenges faced by Italian banks. In this regard, reforms aimed at increasing the efficiency of judicial processes remain key for shortening the recovery time and increasing the value of NPL collateral, thereby narrowing NPL bid-ask spreads. At the same time, the financial market volatility generated by market concerns about the domestic fiscal outlook constitutes one of the most immediate and key risks faced by the Italian banking system. The authorities should act to regain market confidence and stabilize domestic financial markets in order to reduce risks related to the sovereign-bank nexus.

The Acting Chair (Mr. Furusawa) noted that Italy was facing a challenging situation. Real incomes were stagnant, unemployment was elevated, poverty had risen, and public debt was high. The authorities were focusing on lifting growth and addressing pressing social issues. They had also recently reached an agreement with the European Commission (EC). In addition, they had moved forward on the insolvency reforms. Nevertheless, Italy remained vulnerable. Comprehensive structural reforms and policies were needed to put debt on a firmly downward path and lift growth in a durable manner.

Mr. Fanizza made the following statement:

I thank Directors for their gray statements and the attention that they have devoted to Italy. My authorities highly value their inputs. I thank the staff for their hard work and patience also because the establishment of the new government made the consultation discussions longer than usual.

I would like to comment on a few perceptions of my authorities' policies that emerged from the gray statements. Let me start with the fiscal policies. My authorities have not embraced an expansionary fiscal stance for 2019. In fact, the approved budget law implies no fiscal stimulus because the structural balance will stay unchanged. Starting from 2020, the intention is to improve the structural balance. Let us be clear: This constitutes a major shift from the policy announced in September. My authorities believe a revised staff appraisal should have reflected this shift. We appreciate that the staff report was circulated well in advance of our meeting, but it is clearly unfortunate that this made some of its content out of date. In this regard, I fully agree with Mr. Moreno on the need to reconsider our Transparency Policy.

Second, I am glad that Directors have acknowledged the significant progress made toward strengthening the banking sector. Higher sovereign spreads amid political uncertainty have not affected interest rates on loans to households and firms. In fact, the cost of credit has remained basically unchanged since the summer. This favorable outcome demonstrates that the regulatory reforms that have been implemented have been effective. Nonperforming loans (NPL) have halved since the peak in 2015 and, as a percentage of total loans, are now 4.5 percent net of provisions. It is true that the systemic banks have done most of the job, but smaller banks have already started to tackle the issue. In January 2018, the Bank of Italy issued guidelines for small banks on the strategies to reduce NPLs, which have been duly prepared and submitted to the regulator. My authorities regret that the staff report does not acknowledge this important step.

Third, with regard to structural reforms, my authorities, the staff, Directors, all agree that structural reforms are the real issue to lift productivity and growth in a durable manner. My authorities, however, believe that a precondition for their success is to recompose the social divide that has been widening since the global financial crisis. This is why they have introduced the citizenship income and modified temporarily retirement rules. There is no backtracking on formal and informal reforms. The government has not reverted the Job Act. The most controversial measure was a reintroduction of stricter rules for renewing temporary contracts. This measure concerned less than 0.3 percent of employees. The introduction of the citizenship income gives more power and resources to an agency set up by the Job Act to conduct active labor market policies. We greatly appreciate the staff's emphasis on structural reforms.

Let me note that the staff strongly advocates that we should decentralize the wage bargaining system to better align wages with productivity. I could not agree more. That is the right measure. However, this proposal implies that for workers in the same industry, wages would be lower in the south than in the north. It turns out that the largest party in parliament has its electoral basis among low skilled workers in the south. The minister of labor happens to be its main leader. Do we really believe the proposal could gain traction under these conditions, as noted by at least three Directors?

The first time the staff put forward this proposal was in the context of the 1983 Article IV consultation. My predecessor and friend, Mr. Leipold, had just joined the Fund and participated in the mission. Our policy advice should try to focus on policies that are actually implementable. There is no point in giving the right policy advice if no one is listening.

Mr. Meyer made the following statement:

I have issued a comprehensive gray statement, also in coordination with my EU colleagues. I will highlight a few points for emphasis.

First, on the positive side, we highlight the resilience in the Italian economy. Growth in 2017 was its highest in a decade, the employment rate has increased, and important progress has been achieved in repairing the banks' balance sheets. However, we must not ignore the substantial vulnerabilities. The staff's analysis shows that low productivity growth sets Italy firmly apart from other euro area members and that high public debt is a source of concern. Moreover, improving weak social outcomes will also require substantial structural changes. The financial sector is still suffering from legacy assets and low profitability. We, therefore, strongly encourage the authorities to tackle these challenges and welcome that these issues are on the Italian authorities' agenda. At the same time, we are concerned that the authorities' reform strategy falls short of the comprehensive reform package that is needed, and that some of the government's flagship measures might not go in the right direction. Such a comprehensive reform package should include all three policy areas: fiscal, structural, and the financial sector.

First, a gradual and growth-friendly but sustained fiscal consolidation will be required. This will eventually create more fiscal space, through low interest rate payments and improved investor confidence, and would help untangle the sovereign-bank nexus. In this regard, we explicitly welcome the authorities' intention to put public debt on a firm downward path and the fact that the modified 2019 budget now avoids a structural deterioration. But we would also like to point out the significant degree of uncertainty as regards the net economic effect of the announced budgetary measures. As regards specific fiscal consolidation measures, we see a particular need for comprehensive reform, especially by modernizing the safety net and lowering the tax wedge on labor while broadening its base. We also agree with the staff that the quality of public finances should be improved, along with productivity-enhancing public investment.

Second, we see a need for deep structural reforms that focus on supply-side measures. We note in this regard the staff's proposal on a wage bargaining system that brings wages more in line with productivity and liberalizing product and services market to lower barriers to competition. I take into consideration Mr. Fanizza's remark on the political economy. My comment on that probably would be an insider-outsider argument. Bringing in more people into employment would be a positive development. On the structural front, moreover, we see merit in modernizing public administration and reforming the insolvency system, and take good note of recent laws and legislative initiatives in these areas.

Finally, as regards the financial sector, we would like to acknowledge the significant progress made in reducing the stock of NPLs, which now stands around 10 percent of total loans in gross terms. To further strengthen the resilience of the banking system and its ability to fully support the real economy, continued progress is needed in repairing banks' balance sheets.

With this, I wish the authorities all the best.

Mr. Moreno (CE) made the following statement:

We have issued a gray statement, and we share the comments that were just made by Mr. Meyer. We would like to highlight a few issues.

First, on the general analysis, we note that there is agreement between the staff and the authorities, and we also agree with the analysis on addressing the key problems of weak social outcomes, low productivity, and high public debt levels, which are longstanding problems of the Italian economy.

On the recommendations, we note that there is a difference in the fiscal consolidation path and on the pace of structural reforms. Here, we side with the staff on the need to accelerate fiscal consolidation and the recommendation of having a structural adjustment of 2.5 percent of GDP in the next four or five years, which would also be broadly consistent with the EU rules.

With respect to the structural reforms, we take note of the measures taken by the authorities and the comments made by Mr. Fanizza. Notwithstanding the difficult political economy considerations, we would also encourage the authorities to step up with a more comprehensive and ambitious structural reform package.

I would like to make a few more specific comments.

First, on the debate on collective bargaining, I too feel that the staff is having a one-size-fits-all approach for company-level bargaining across the board, at least in European countries. There is analysis both inside the Fund and the OECD, that shows where it is useful in terms of wage flexibility, but there are other considerations in the labor market—such as employment wages, the quality of the employment, inequality—that should also be taken into account. It might be useful to engage in a more nuanced analysis of the collective bargaining. I am not talking about just Italy, but in general, in the European Department (EUR), it would be useful if we could have a more detailed analysis of their collective bargaining approach, which we feel is too narrow.

My next comments will be directed to the Strategy, Policy, and Review Department (SPR). One of them is referring to paragraph 15 on spillovers. We feel that the message there is not consistent with what the World Economic Outlook (WEO) and the World Economic and Market Developments (WEMD) are saying about Italy. This paragraph's narrative is that there are high risks because there was a spillover event in May. It minimizes the fact that nothing has happened since; whereas the WEO is the other way around. There are no major spillovers. To quote from the WEO update, "Spreads for the other euro area economies have remained largely unchanged over this period." The narrative should be the opposite. There is not much risk, although there was an event in May, and we will keep looking into it.

Furthermore, paragraph 15 includes an unwarranted reference to 2010. The world has changed significantly since then, certainly the EU, if only because we have created a banking union, and we have a European Stability Mechanism (ESM). Spillovers is not the story of 2010. The reference is unwarranted. There are also some impositions there, when the staff is talking about the holdings of debt of the Spanish bank, which I do not think is that significant. I would call on SPR to be more cautious and consistent in the language. We prefer the language of the WEO, which is based on establishing the differences in countries. It is doing it not only for advanced economies but also for emerging economies. That would also be a more evenhanded treatment.

Finally, with regard to Mr. Fanizza's point about the review of the Transparency Policy. We have a report that is clearly outdated. The cutoff date was December 18, so the staff needs to do something in order to have a report that is more up to date.

Mr. Di Tata made the following statement:

We thank staff for the comprehensive report and Mr. Fanizza for his informative buff statement. We issued a detailed gray statement but would like to emphasize a few issues.

Italy's main challenge is to address low growth. Addressing the low growth performance requires a significant strengthening of the structural reform content of the authorities' strategy, focusing on labor and product market reforms. As noted by staff, decentralizing wage bargaining to facilitate a realignment of productivity at the firm and regional levels, lowering the cost of dismissal, and reducing impediments to competition constitute key areas for reform.

In response to one of the questions in our gray statement, staff has provided interesting information about the large regional disparities in productivity, unemployment, and informal activity between the north, central, and south of Italy. However, the political feasibility of decentralizing wage bargaining at this stage seems low. Against this backdrop, the new coalition government has decided to focus on a limited set of agreed structural reforms. We welcome the efforts underway to improve the business climate, including the new anti-corruption law, the actions to enhance the efficiency of the public administration, and the reform to overhaul bankruptcy and insolvency procedures, which should be broadened to include the specific regime for large enterprises. Ensuring the effectiveness of these measures, however, requires enhancing managerial and administrative capacity.

The authorities need to pursue a credible medium-term fiscal consolidation effort, accompanied by improvements in the quality of policies to reduce the government's large gross financing needs and put the debt-to-GDP ratio on a firm downward path. Avoiding a heightened stress scenario is of critical importance, given the possible significant global and regional spillovers.

While we welcome the authorities' plans to contain the fiscal deficit for 2019 within 2 percent of GDP to comply with the EU fiscal rules, further fiscal efforts are required over the medium term to ensure sustainability and reduce distortions. There is a need to ensure the viability of the pension system, reform the tax system, broaden the tax base and lower the tax wedge on labor, stimulate employment and strengthen tax administration, and establish adequate controls for effectively targeting the citizenship income program. The government's plans to gradually increase public investment and enhance its efficiency are welcome.

We welcome the significant progress made in recent years in improving the health of the banking system by reducing problem assets and strengthening capital levels. Looking ahead, further efforts are needed to fully restore the resilience of the system. In addition, links between the sovereign and the financial sector should be monitored closely, given banks' and insurance companies' large holdings of government securities.

Mr. Ostros made the following statement:

I share the overall analysis and narrative expressed in the report. I also share the staff's concern that some of the proposed reforms by the government seem to deepen the structural impediments in the Italian economy, rather than solve them.

I thank Mr. Fanizza for a very informative buff statement, and I also associate myself with the gray statement issued by Mr. Meyer and his intervention.

Low growth has been a trademark of the Italian economy for far too long. A large part of this is explained by structural rigidities, as well as the very high public debt, which is weighing on growth. There are large synergies in addressing both, and I strongly encourage the authorities to reform. The revised budget agreed in December last year was a necessary step in the right direction, yet I agree with the staff's assessment that the planned fiscal stimulus is merely shifted further out and that the safety clause of a significant VAT hike based on the historical track record has its weaknesses.

It is important that we do not take a static view on Italy but a dynamic view, as the staff is doing in the reports. The vulnerabilities and the risks, including spillover risks, are still there, even after the revised budget. There is a need for placing public debt on a clear downward path through credible actions.

I am still concerned about the sovereign-bank nexus, given the large holdings. We should not view this through a static perspective, even if there are only limited signs of pass-through to higher funding costs for the real sector when we know that the vulnerabilities and the risks are still there.

We know that the current global and financial cycle is reaching the typical late stage. Given the limited monetary policy space, as well as fiscal space, it is time to build buffers and reform.

With this, I would like to wish the authorities all the best.

Mr. Trabinski made the following statement:

Italy’s improvements in growth and the authorities’ commitment to the reform agenda is encouraging and gives hope for addressing longstanding economic impediments. Nevertheless, high debt, structural weaknesses, and existing vulnerabilities in the banking sector require a sustained effort to put the economy on the right track. In this context, Italy would benefit from a more comprehensive reform approach, as indicated by Mr. Meyer.

We issued a gray statement, but I would like to emphasize two additional points.

First, we support the staff’s assessment regarding the need for a credible fiscal consolidation. Policies aimed at increasing revenues and reviewing government spending would be important to put debt on a downward path. We encourage the authorities to consider a more thorough reform of public administration and review of the institutional arrangements, which could generate much-needed efficiency. Moreover, we support the staff’s recommendations regarding the need for a comprehensive tax reform aimed at broadening the tax base, eliminating tax compliance gaps, and achieving simplification. By doing so, the authorities could unlock Italy’s economic potential.

This leads me to a more general remark about Italy’s business environment. Existing market inefficiencies and the aforementioned complex tax system, problems with adaptation to the changing global market environment are hampering the business environment and further productivity growth. While the authorities’ efforts focus on modernizing the insolvency framework, raising public investment and cutting red tape are encouraging, more needs to be done.

The liberalization of product and service markets, recommended by the staff, would be good examples of what can be achieved to improve the business environment. In this sense, we believe that future Article IV reports would benefit from a more detailed analysis and recommendations of the enterprise sector in Italy.

Finally, we thank the staff for answering the questions enclosed in our gray statement, and we wish the authorities success in their endeavors.

Ms. Levonian made the following statement:

We issued a gray statement, so I only want to raise a few points.

First, I thank Mr. Fanizza for his buff statement and personal attention, which has provided a helpful context for the recent developments and also provided some nuances in certain areas. For instance, it was a positive surprise to read that Italy has issued EUR 390 billion in securities in 2018, at an average issuance cost of only 1.07 percent, which provides a bit of context on this issue. That being said, we agree with the staff that, looking forward, Italy needs to put debt on a more sustainable path and that fiscal spending should also be more inclusive, including across generations. We fully support the staff's point—and judging by Mr. Fanizza's opening remarks, also the authorities' point—that the challenges are structural in nature and that most need to be prioritized to improve the growth prospects and turn the fiscal dynamic.

We have some concerns with respect to the looming bank funding cliff in 2020-21 that the staff has outlined in Box 3. It is a sizable amount of cheap ECB instruments that will be maturing and could expose Italian banks to a potential large gap in their liquidity. Perhaps the staff could provide an assessment of banks' preparations to deal with this issue.

In closing, I would like to make two further points. One, I would like to ask the question that we had posed in our gray statement. On the issue of decentralizing wage negotiations, given the political economy considerations, is there an incremental approach that could be taken or alternative ways of reducing structural unemployment in that respect?

I would also lend my support to the comments that have been made with respect to a review of the Transparency Policy.

Mr. Just made the following statement:

We commend the staff for their good reports. If it was not for political economy constraints, this would be a good blueprint for the authorities.

We thank Mr. Fanizza for his opening statement and associate ourselves with Mr. Meyer's intervention.

The long-term performance of the Italian economy has been disappointing, leading to weak social outcomes. The deeply rooted structural rigidity should be urgently addressed in parallel with credible fiscal consolidation, which will be beneficial both for the sustainability of the public debts and financial stability. It would equally be beneficial for Italy's neighbors, who may, in addition to the German supply chain, hold bonds in the Italian supply chain.

We welcome the recent moderation of the fiscal stimulus plan but currently do not see much room for an expansionary fiscal policy. We are concerned by the harsh reversal of the previous pension reform, which exacerbates the skew of social spending toward the older generations.

A moderate increase in growth-enhancing public investment is warranted but should be offset by appropriate cuts in the current spending and complemented by improving the procurement and governance framework efforts.

We also support the staff's proposal to improve the efficiency of the tax system and broaden the tax base, for example with an effective property tax.

We welcome the progress in strengthening the banking sector and encourage the authorities to continue their close supervisory oversight of NPL reduction strategies. The consolidation of smaller banks, followed by asset quality reviews of the newly created entities, should also be pursued in a timely manner.

The strong nexus between the sovereign risk and the health of the banking sector remains a major concern, with significant spillover risks. The fact that last year's sharp widening of sovereign spreads has not resulted in the tightening of the lending standards is welcome, but we also believe that it is not a source of complacency. Perhaps the currently ongoing Financial Sector Assessment Program (FSAP) will shed light on Mr. Fanizza's point that the strengthened regulatory framework has contributed some to these welcomed developments.

Improving the competitiveness through decentralized wage bargaining, enhancing the potential output through multi-pronged structural reforms is essential for lifting the Italian economy from the low growth trap.

The recent proposals to overhaul the insolvency and bankruptcy frameworks are a step in the right direction. We encourage the authorities to pursue the agenda, including the special insolvency regime for large enterprises. Measures to liberalize product and service markets, simplifying administrative procedures, and reforming state-owned enterprises (SOEs), with a view to privatize some of them, are important elements of a much-needed broader structural reform.

Mr. Beblawi made the following statement:

We issued a gray statement, so I would like to emphasize two points.

First, we welcome the Italian authorities' commitment to pro-growth policies that are consistent with placing Italy's high debt-to-GDP ratio on a declining path, as expressed by Mr. Fanizza. However, like Mr. Meyer and others, we encourage the authorities to adopt a more comprehensive structural reform strategy to address Italy's persistent low growth and raise productivity. We understand that the realities on the ground make it difficult to reach a wide consensus on such a package. However, until this is possible, we welcome the authorities' commitment not to erode the hard-won reforms achieved over the past few years, such as tax and pension reforms, a risk that is highlighted in the staff report.

Second, we acknowledge the authorities' efforts to safeguard financial stability and encourage them to continue to foster resilience in the financial sector, including by strengthening bank balance sheet, enhancing banks' governance, and expediting the ongoing consolidation of the smaller banks. This is particularly important given the risks highlighted by the staff in Box 3 and throughout the report of the impacts of the rising sovereign yields and the strong sovereign-bank nexus' impact on Italy's financial and fiscal stability.

We wish the authorities success in their endeavors.

Mr. Kaizuka made the following statement:

I will start by congratulating Mr. Fanizza and the authorities on the very recent developments and achievements. Having said so, while Italy did avoid an excessive deficit procedure at the end of last year, it continues to face significant challenges and vulnerabilities, including stagnant productivity growth and NPLs and public debt. Against this background, we concur with the staff that the package of structural reforms, a credible fiscal consolidation, and bank balance sheets strengthening, are the only durable ways for Italy to improve outcomes and enhance its resilience. There should be a strong comprehensive policy package, as Mr. Meyer elaborated, and a steady implementation of those policies on every front.

Let me turn to the public debt. The public debt remains very high, at above 130 percent of GDP, and it is a vulnerability to adverse shocks. Credible fiscal consolidation is indispensable. Against this background, we underscore the importance of implementing a comprehensive reform of the tax system. Moreover, a reversal of pension reform should be strictly avoided from both fiscal consolidation and labor force participation perspectives. At the same time, promoting competition and improving the business environment is critically important for raising productivity, which is much lower compared with European peers. On this front, it should be welcomed that the authorities are engaging in improving the justice system and the insolvency framework. Nevertheless, as labor and product market rigidities and the buildup of corporate debt have negatively affected Italian productivity, we encourage the authorities' to make further efforts to implement labor and product market reforms and facilitate firms' dynamism, which are indispensable to tackle Italy's structural rigidity and boost potential growth. In this particular regard, the staff provide make more granular advice on specific measures in labor and product market liberalization.

Finally, on the financial sector, there has been progress in reducing the level of the NPLs, as Mr. Fanizza rightly pointed out. But the challenge now is to address the problem of the low profitability of banks, especially small ones. Further efforts are needed to enhance the profitability, including through the restructuring of financial institutions to ensure financial stability.

With these words, I wish the Italian authorities every success in their endeavors.

Mr. Tombini made the following statement:

I thank the staff for the set of reports and Mr. Fanizza for his insightful buff statement and for today's update.

On the fiscal stance, we have raised the issue, what was the new assessment after the budget that was approved late December? I am sympathetic with the view that these new assessments should be reflected in today's discussion on Italy.

We issued a gray statement, and I have three main areas, reading the comments of other Directors. First, on the structural reforms, nearly all Directors support the idea of having a wide range of structural reforms, relying on the supply-side of the economy. The thing that I am missing from the analysis—I want to hear from the staff—is whether we have an idea of the impact of the various reforms on potential output growth and also perhaps an assessment of political support. We have seen this in other Article IV consultations. For example, in Brazil's 2018 consultation, there was a matrix where that showed impact of the reforms and the political support. I would like to hear from staff on this issue.

The second is an issue that was not touched upon in the discussion so far, which is the normalization of monetary policy by the European Central Bank (ECB). We expect that normalization will take place, including the unwinding of the balance sheet of the ECB. We have the experience now with the Federal Reserve. It has a very large balance sheet now and is doing the unwinding in a very predictable fashion, basically on automatic pilot.

In the case of Europe, it is a bit different because we do have a large sovereign bond market but it is very fragmented. The market conditions to allow for the unwinding would depend not only onEuropean-wide market conditions but more on those countries which are under more fiscal duress, like Italy. I want to hear from the staff whether this was part of the dialogue with Governor Visco and with the ECB, on how this unwinding of the balance sheet will proceed, having in mind the case of Italy, because market conditions in the Italian market will determine the scope and the modalities that we will have to adopt in terms of normalization.

The last item, which was raised by many Directors is this sovereign-bank nexus, which is an important issue. Regulatory and supervisory authorities have to have an eye on that. If one thinks that there is an exceptional risk facing the sovereign in terms of a deterioration of the credit quality, which will impact the balance sheet of the banking system, especially in Europe, then one has the instruments already. We do not need to think about the international regulatory forum to take care of that because this kind of reform is now stalled in the Basel Committee. There is no appetite to deal with the unintended consequences from monetary policy, for liquidity management, and so on. The dialogue of the Fund has to be with the supervisory authorities, but through the use of Pillar II, which is the right instrument to deal with this issue in case this risk is important.

Mr. Doornbosch made the following statement:

I thank the staff for this candid report. It is important for the Fund to be able to speak truth to power, and I believe this staff report lives up to this promise.

I also thank Mr. Fanizza for his opening remarks. This was an enrichment of our debate this afternoon. I associate myself with the gray statement and the opening remarks of Mr. Meyer.

For us, the key of the staff report is that we strongly agree that in order to effectively tackle Italy's structural rigidities, measures beyond public administration and insolvency are needed. The focus of the reform should be squarely placed on the labor and product markets, as the staff indicates in its report. However, I would like to start with the glass half full.

In his work, Mr. Fanizza writes that the governing parties are focusing on a limited set of measures specified in a government contract. Some of these measures are important for improving the fabric of society. Measures to address corruption, strengthen the insolvency framework, and improve the efficiency of public investments are important steps in the right direction. In our gray statement, we have cited the study by Luigi Zingales that argues that reforms in exactly these areas are priorities for Italy to support productivity growth. That is something positive to build on and to see how best to support these efforts of the Italian Government.

However, there is also a glass half empty part. It is important because there is limited progress on other fronts. While we sympathize with the goal of addressing pressing social issues and improving growth prospects, some of the government's measures risk achieving exactly the opposite. And I would like to point out two. The first one is from a fiscal sustainability perspective. Mr. Fanizza points out that the reduction of the deficit in the adjusted 2019 budget is an improvement compared to the initial budget. But as the staff points out, it is still a deterioration of the structural balance by 0.3 percent or, if we take the calculations of the government, by 0 percent. It is still going in the wrong direction. It is less bad, but it is still bad. From a social inclusion perspective, we find it hard to see the merits of the reversal of the pension reform, as the staff report suggests that the young are the group with the highest risk of poverty. From a growth perspective, we have difficulty understanding the authorities' reasoning that the reversal of the pension reform could foster youth employment and labor productivity.

On the point raised by Mr. Tombini about the financial sector, we believe that the purchase of Italian Government bonds by the domestic financial sector is an unwelcome development. We see exactly the opposite of what we would like to see. We see an increase of domestic holdings of the banks in Italy. It is not enough to wait until this risk materializes, but it is important for supervisors to be proactive in trying to address this issue before the risk becomes apparent. In that sense, I disagree with Mr. Tombini's suggestion to leave this up to Pillar II to address this issue. Maybe it stalled in the Basel Committee, but it is something that we can address in Europe.

Finally, I have a question to SPR. We wondered in our gray statement why the staff had chosen to classify Italy as having fiscal space at risk. In the answer to technical questions, the staff provided us with the definitions of the categories. We know the definitions, and we were referring to them in the questions. But what we tried to ask is how the staff is using the definition in this case. It seems that the way staff uses the definition is, a country would only be categorized as having no fiscal space when it is on the brink of losing market access; but at that point, one does not need the complicated framework anymore to assess that there is no fiscal space. Related to this, paragraph 18 in the report refers to the Debt Sustainability Analysis (DSA), but then the topic sentence is based on the fiscal space framework. It is unfortunate that the report mixes the two frameworks. We would appreciate it if that no longer happens.

Ms. Pollard made the following statement:

We agree that this is a case where the staff's analysis and candor were quite welcome, and we share the analysis.

I also support many of the comments that have been made around the table already and support Mr. Tombini's comments, in particular, on adding more on the effects of monetary policy on Italy and also on the idea of creating a matrix of reforms that look at the potential effects, as well as the political difficulty of implementing those reforms.

For a long period of time, persistent structural weaknesses have prevented the Italian economy from realizing its potential, leading to disappointing outcomes for its citizens, and now, combined with very high public debt and the sovereign-bank nexus issues, there are considerable downside risks facing the economy.

Like others, we welcome the revisions to the 2019 budget, but I agree with Mr. Doornbosch, that in some ways, it is really just a better bad outcome.

A more challenging issue, certainly for the long term, is the need to advance a comprehensive structural reform agenda to unlock higher potential growth. We welcome some of the recent measures that have been implemented to reduce corruption and improve the business climate; but, like Mr. Ostros, we share the staff's concerns that some of the measures adopted recently could be moves in the wrong direction. We particularly see this with respect to the backtracking on pension reforms that could decrease labor force participation, worsen public finances, and have the unintended outcome of increasing intergenerational inequities, rather than benefitting the young.

The staff report provides a convincing analysis that the single sectoral national wage contract does not allow for sufficient wage differentiation to match the regional level productivity differences. However, at the same time, I take note of Mr. Fanizza's comments on the political economy concerns of this proposal. I am quite interested to hear the staff's responses to Ms. Levonian's question about whether there is a way to address these issues through some gradual process.

I strongly urge the authorities to pursue decisive measures to improve labor market dynamics and boost productivity. I agree with Mr. Meyer that there is merit in modernizing the safety net and in lowering the labor tax wedge while broadening the labor tax base and then broadening the tax base overall.

Finally, we urge the authorities to continue to make progress in strengthening bank balance sheets, reducing the sovereign-bank nexus. We were glad to see, in Mr. Fanizza's statement, that the authorities have committed to do this.

Mr. Jin made the following statement:

The Italian economy has achieved a modest recovery in the past decades, with growth in 2017 at a decades high and the labor market conditions improved. We commend the authorities' efforts to strengthen the banks' balance sheets. Banks have strengthened their capital base and improved their credit quality since the crisis.

We also commend the authorities' efforts to tackle corruption and improve governance. The anti-corruption law that was adopted last year is a good indication of the authorities' determination in this regard. We share the staff's suggestion to consider decentralizing wage bargaining as a priority. Setting a more differentiated minimum wage system would help to reduce labor market rigidity and bring labor costs in line with productivity.

Finally, we ask for the staff's opinion on monetary policy, whether the ECB's current monetary policy stance is appropriate for the Italian economy. This part has not been fully analyzed in the report.

Mr. Gokarn made the following statement:

I have three relatively small points. The first is in relation to a question that we asked, for which we have not gotten the answer in the technical responses. This has to do with an issue which many Directors addressed, which is the change in the budget framework, the compliance with the EC proposals. That has resulted in the deficit numbers being moderated over the next three years. We wanted to get a sense of what benefits this would have in terms of the quantum of debt, how would it contribute to the debt sustainability. We want to see some quantification of this effect, which we did not find in the report.

My second point, which then leads to my third point, concerns the broader issue which Mr. Fanizza raised in his opening remarks about policy advise. The specific point we have is about the weak social outcomes that the report addresses, stagnation in personal incomes, high unemployment, and eroding standards of living. This is creating a political economy environment that may be favorable to more radical reforms or not. Some judgment on that would be welcome. But in terms of the specific measures that the authorities have proposed, what is the staff's assessment of its impact on all of these social indicators?

Linking with this is the point that Mr. Fanizza made about advice and traction. It is a general point that applies to any issue that the Fund provides advice on. I would disagree with him on confining Fund advice to what is possible because the Fund, in terms of addressing the first-best, contributes significantly to the wider policy debate on what needs to be done. There may be agreements or disagreements, but providing a benchmark of what the best policy response to a given situation is a useful contribution from the Fund. But there may be some middle ground—Ms. Levonian and Ms. Pollard also addressed this—which is to look at the current situation as it exists and to offer options that may be consistent with an existing political economy situation. In other words, it cannot be an all-or-nothing. There is good policy but no possibility of implementation, which adds little value to the debate. There is nothing to do otherwise. The advice should be somewhere in the middle, where a combination of feasibility and desirability is found. Among the choices that political economy will support, what are the best things that one can do? This may be one way to reconcile those positions.

Mr. de Villeroché made the following statement:

I would like to associate myself with Mr. Meyer's points, his written and oral statement.

I will start with a picture that needs to be balanced. We see some positive developments, and we have important concerns. I will start with the positive developments. Definitely, we had good news in terms of growth in 2017. It is long overdue since it has been following a decade of very low growth, if not stagnation.

A second point that we see positively is the recent progress and the resilience in the banking sector in a difficult environment. There was definitely a sharp decline of NPLs. It is certainly not sufficient and needs to be continued. Looking at the recent developments of the banking sector, despite a hike in spreads, the credit conditions to the economy deteriorated but not much. That is good news as well. We could have expected a worse outcome in terms of financing of the economy. It tends to demonstrate that the position of the banking sector has improved over the last years.

Third, the positive news is the agreement reached with the EC on the fiscal side. Maybe it is, like Mr. Doornbosch said, only less bad. But I would say that what is important is not only the outcome for next year but the fact that the authorities are committed to respect EU fiscal rules. It was not a given when one considers the campaign which led to this coalition.

There was an agreement between Italy and the EC, and I hope that this agreement demonstrates that Italy is committed not only for next year but for the following years to EU fiscal rules.

What is more concerning is the medium-term outlook and the challenges in terms of structural reforms. I associate myself with most of the Directors who underlined the necessity to lift productivity in Italy. I definitely support the point made by Mr. Moreno on the need to go deeper in the functioning of the labor market to understand why wages have been above productivity in Italy at a time where, in other countries in the euro area, they were below, which has had quite an important impact on the Italian economy.

There are other reforms which need to be addressed, such as the product market rigidities and the need to enhance competition. There is a lot of debate within the coalition on these reforms. Maybe there is a time for the debate and the debate is alive. That is the least we can say. My concern is what will be delivered. Since it is a long challenge that Italy is facing on structural reforms, the lack of clarity is not completely reassuring.

Mr. Palei made the following statement:

Italy is an exciting case study, important for most of us. We have a country which has relatively strong fundamentals. It is well balanced. It has a current account surplus. It has a good debt profile. It has an exchange rate that is close to equilibrium. It has many other positive features. But it does not have growth, and it has very high public debt, which is a concern. The question is, what to do with it? The staff came up with this comprehensive package. Mr. Tombini asked for a table, showing us different parts of this package, comprehensive package. If I understand correctly, they are a part of this working paper that was mentioned in the report.

There is a table with a simulation strategy, with all the shocks. All of them are quantified, and all of them are listed briefly in the report itself. We can see how much we can get from public administration reform, from firm-level wage bargaining, and so on. All of them are quantified and listed.

The staff says Italy should do all of this. That is the policy advice the Fund has for the country. Mr. Fanizza has a clear point. It is not possible to do all of this at once. Political economy does not allow it, not in Italy and not in many other countries.

We should move toward something that we described in our gray statement and that Ms. Levonian mentioned. What would be the feasible strategy? What are the priorities? What are the binding constraints on economic activity? We need a diagnosis. We need to prioritize the reforms. We need to find what is feasible and is the most efficient under the given circumstances. There is more work to do. I hope that in the future, we will see more prioritization and the authorities will continue their dialogue with the staff. Otherwise, it will be difficult to gain traction with the authorities and for the Fund to be effective.

Mr. Virolainen has returned to Finland, but we recently discussed its economy. The country had very good structural reforms. The country is also very transparent, one of the best in terms of governance and other features. Yet this country had no growth over the past decade, very disappointing growth. The country has doubled its public debt-to-GDP, from about 30 percent to more than 60 percent. That is another puzzle we have to deal with. The cannot advise the country to embark on shock therapy that would be overarching and include all the elements we can think of. We need to be a little more selective. I hope this point will be reflected in the summing up.

Mr. Mojarrad made the following statement:

Like Ms. Levonian, we appreciate Mr. Fanizza's update on the recent favorable policy developments in Italy, which may not have been fully reflected in the staff report issued six weeks ago.

Second, like Mr. Moreno and Mr. Gokarn, we agree with Mr. Fanizza on the political economy constraints in policymaking in Italy, especially on some key reforms, such as decentralized wage setting.

Finally, like other Directors, we associate ourselves with Mr. Fanizza's call for a review of Fund's Transparency Policy.

The staff representative from the European Department (Mr. Goyal), in response to questions and comments from Executive Directors, made the following statement:[8]

Allow me to address the questions in three broad groups. The first is on fiscal policy, the second on structural reforms, and the third on monetary policy and financial sector issues.

On fiscal policy, let me address two points. One is on whether the stance of fiscal policy is neutral or expansionary, and the other is on the fiscal risks in the staff appraisal.

On the fiscal stance, the way we do our projections is to look at the budget for the current year, but for future years, to consider what is feasible

[8] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

based on established measures. This is the standard approach and guidance provided by the WEO.

What we find is that the fiscal stance is moderately expansionary for 2019 but considerably more expansionary in 2020. This is because of the political infeasibility of the VAT safeguard clause. As noted in the technical responses, the VAT safeguard clause has been repeatedly resorted to for the last five years but never implemented. Instead, most of the time, the deficit target was changed. A shrinking deficit target would be announced for future years, but when the time would come, the deficit target would be raised because of the need for flexibility or various other reasons.

Soon after the current parliament came to power, they voted against the VAT safeguard clause. Even after this new budget was passed by the government, the two political leaders of the government said that there would be no implementation of the VAT safeguard clause. Taking into account these statements and the political feasibility of whether the VAT safeguard clauses will be implemented, staff’s assessment is that fiscal policy will be considerably more expansionary going forward.

The implication is that debt will, at best, remain stable over the next few years and then rise thereafter. It would rise, in part, because of monetary policy normalization as detailed in our DSA. Our sense is that, as monetary policy normalization occurs gradually, interest rates will go up. Given current policy, given how we see potential growth for the economy and our outlook for the primary surplus, debt is likely to rise in the baseline over the medium term and over the longer term,.

Meanwhile, if Italy gets hit by a shock, such as a slowdown in growth or a recession, or if the fiscal stance evolves in the opposite direction to what the authorities have stated, debt will rise earlier and faster. This is why the thrust of our staff appraisal remains unchanged. When we look at the measures that the authorities have implemented in the 2019 budget, essentially, the decisions for consolidation have been postponed by a few months and will need to be taken up again at the end of this year.

Turning to structural reforms, there were a number of questions on political feasibility. One question was: What have been the lessons of past experience with structural reforms in Italy? Unfortunately, the experience has not been very successful. In the past two decades, Italy has legislated a wide range of reforms. There have been at least 4 labor market reforms. There have been 11 public administration reforms. There have been 3 education reforms.

There have been numerous judicial reforms and multiple packages to cut red tape and simplify bureaucracy.

Many of these reforms were covered in previous staff reports and, in fact, supported by the Fund. Regrettably, even though these reforms were legislated, their effect has been quite weak in terms of translating into higher income growth, productivity growth, or in terms of tackling high structural unemployment.

There are several reasons for why there have been serial failures in how these politically feasible reforms have translated into outcomes. One is implementation challenges. Reforms are generally legislated but changes on the ground have been much more limited because of challenges at various levels of government in taking forward the reforms that were legislated. This hampered public sector reform, public administration reform, and the liberalization of product markets.

A second reason is reforms that were legislated suffered from push-back by vested interests, which ended up weakening them. In the staff report, we have detailed how this has happened in product market reform in the past year and a half. The annual competition law, which was supposed to be legislated every year since 2009, was legislated for the first time in 2017. But it was weakened in parliament in order to achieve political consensus. Once it was passed, subsequent discussions for last year's budget inserted a number of clauses that weakened it further. It is a case in point of how, unfortunately, some of the reforms have been weakened.

A third reason is that, oftentimes, the reforms have not gotten to the crux of the problem. Let me highlight the labor market as an issue here. Usually, the objective is very good. The objective of the dignity decree that the authorities passed right after they took office was to restrict temporary work contracts because many employers had been resorting to such contracts which, in the Italian terminology, increases the amount of precarious employment, unfortunately, affecting younger generations disproportionately. The intention is very good.

But it is worth analyzing the reason why employers often use temporary contracts. The reason is that wages are much higher than labor productivity because wages have increased over the last 20 years much more than labor productivity. Employers are looking for cheaper and more flexible forms of employment to be able to cope. Unless a solution is found to high unit labor costs and to the fact that wages have grown much more than labor productivity, regrettably, the incentives of employers will always be to find some way to economize on labor. Therefore, there are likely to be consequences that are not in line with the intended reform.

What does this mean for staff's advice? A chart in a selected issues paper last year and in the staff report this year quantified the benefits over time of the implementation of various reforms. In very brief terms, a comprehensive reform package would imply roughly a 10 to 15 percent increase over 10 years in real GDP. This is significant. It improves competitiveness and reduces structural unemployment.

There is not much political support for this package, however. The packages for which there has been political support have not yielded much results. If we limit ourselves only to such packages with political support, we would need to draw the macroeconomic implications. If the recommended reform package is not implemented, it fundamentally means that wages will remain much higher than labor productivity. Structural unemployment will remain very high. For firms—because Italy's unit labor costs are much larger—it means a smaller fraction of resources available for investment. If a larger fraction of firms' earning goes into higher unit labor costs and into paying interest costs and so on, there is much more limited room to invest and employ new workers.

The story pre-crisis was one of Italian firms borrowing in order to invest and employ. But this channel became much harder after the crisis and remains significantly difficult for firms to resort to currently. The result is low growth, low investment, and high structural unemployment.

If this is the scenario going forward, this means that when Italy gets hit by the inevitable adverse shock, or when interest rates go up in the rest of Europe because monetary policy is targeted toward conditions for the broader euro area—not necessarily just to Italy—then debt sustainability pressures at some point will probably come back, and Italy would probably be forced by the markets into a pro-cyclical fiscal consolidation.

Turning to monetary policy and the financial sector, monetary policy setting in the euro area is geared toward price developments for the euro area as a whole. That being said, Italy has been one of the biggest beneficiaries of monetary policy accommodation over the last few years. First, with the announcement of outright monetary transactions (OMT), the reduction of spreads facilitated the Italian recovery. The provision of long-term funding to

Italian banks has also been an important reason why the increase in spreads recently has had a limited impact on the real economy.

There was a question on how banks are preparing for the coming funding cliff. The reality is there has not been much planning because most banks are effectively locked out of the wholesale funding markets. Thus, many are hoping that the targeted long-term refinancing operations (TLTROs) would be extended. It remains to be seen whether and how that will take place.

We did have discussions with the authorities on monetary policy. There are two views. One view is that, if Italy is able to recover alongside the rest of Europe, then normalization of monetary policy will be fine, because it will go along with higher nominal GDP growth and reduction of debt. However, if interest rates begin to normalize in the euro area but Italy is not able to recovery strongly, there will be adverse implications for Italy.

In regard to the sovereign-bank nexus, our understanding of the Single Supervisory Mechanism, the ECB supervisors, is that they will take into account sovereign bond holdings by banks in the Pillar II discussions.

Finally, there was a question on the DSA and the fiscal changes. We tried to answer that in the technical answers. Essentially, there is a very small change of the fiscal and growth numbers for a few years. Beyond that, the changes are also limited. The deficit goes up to close to 3 percent and remains about there, and real GDP growth is around 0.6 to 0.7 percent. In that regard, the changes for the debt projections are also limited.

The Deputy Director of the Strategy, Policy, and Review Department (Mr. Bayoumi), in response to questions and comments from Executive Directors, made the following statement:

I will answer the three questions which were mainly directed to SPR.

On the Transparency Policy question, it is really a question about what Directors think a staff report should contain. What we currently have is a staff report that describes a set of discussions done up to a certain point in time. Any changes due to more recent events get reflected in the staff supplement, which is part of the package which is published, and it issued before the Board discussion. That seems to be a more basic question than the use of the Transparency Policy. Any recent changes are reflected in the staff supplement.

If one starts changing the staff report for events after the discussions are over, then what does a staff report cover?

On the WEO versus the staff report, the purposes are different. The WEO, as its name might suggest, is a discussion about what is happening in the world. Therefore, it is perfectly appropriate at that point to say, there was a rise in Italian yields and not that much happened. The staff report serves a different purpose. The staff report is a forward-looking discussion about what spillovers could come from Italy. It seems absolutely appropriate to discuss what the spillovers could be and their mechanisms. Along those lines, it seems that a discussion of events in 2010 is perfectly relevant since, after all, we believe that the bank-sovereign nexus is an important part of current potential spillovers. That is why the WEO and the staff report dealt with these issues in a slightly different way.

Finally, on the fiscal space at risk, Mr. Doornbosch made a very good point. I take the point that one could argue that the no fiscal space is, essentially, something which would be obvious anyway. I will convey that to the people who do fiscal space and set the policy within SPR. It is a smart point to make, and I will convey it.

Ms. Levonian made the following statement:

I do not usually intervene twice, but this is an incredibly important point.

Regarding the Fund's advice and the question, one could argue that the Fund has to set goal posts in the advice that is provided. As Mr. Gokarn said, it is a good thing to set the debate. This is what one would want in a particular country. But it comes back to the Fund's credibility. It is not just in the case of Italy but in all cases. It is fine to inform the debate, but one can do so while also then suggesting feasible steps in the right directions that are implementable or acceptable.

I make this point in the context of the smaller states that we represent. It is very salient there. With the kind of push-back that is experienced within a country and the kind of reputation that the Fund ends up having in some of these circumstances, I do think it is possible to provide authorities with steps they can take. It would be helpful for the Fund's reputation and the acceptance and traction of its proposals if we set goal posts, but then we help by providing steps for how to get there—especially in some of the constituencies that I represent.

Ms. Pollard, in response to Ms. Levonian's point, asked the staff if it was possible to look at the wage structure and consider steps that could be taken to make it more regional without actually just saying: OK. Now we go from what we have, the national, and then changing that automatically.

Mr. Palei made the following statement:

> In our gray statement, we asked a question about the role of working papers as supporting documents for the report. In this particular case, we had at least three major working papers that were referred to as part of the analysis. I did go to these papers, and I had to read them the way we usually read selected issues papers.
>
> I am not sure what the balance is. I understand that last year, there was a selected issues paper, and this year there were some charts included that summarized the analysis. But I would like to hear some comments on the balance we are supposed to maintain between having an analysis in the working papers, which is attributed to specific staff members and are designed to elicit comments and to encourage debate. But here, we have a report with policy advice. Where is this transition? Where does it take place?

Mr. Meyer made the following statement:

> On this issue of the comprehensive package—and Mr. Palei thought that all this is too much—I thought that the mission chief did a good job in explaining that again.
>
> The way I understand it, the package on the structural front has the wage bargaining plus the dismissal procedures, the liberalizing of product and service markets, and the public administration broadly. The important part here is that those ones are connected to each other, as the mission chief explained. Prioritizing, leaving out one or two and just focusing on one would not be efficient and effective in this regard. The staff is not overdoing it with this package. This comprehensive package is mutually reinforcing and, from that perspective, has our full support.

The staff representative from the European Department (Mr. Goyal), in response to further questions and comments from Executive Directors, made the following additional statement:

> Coming back to labor market issues, the authorities have been taking an incremental approach. Within the two-tier bargaining system, they have emphasized productivity increases at the upper end of the wage distribution. In that sense, they have been trying gradually to widen the distribution. But this approach has not been successful. The wage distribution remains very compressed.
>
> Part of the reason is, as we have noted in the technical answers, the wide coverage of the labor force under the sectoral national wage contracts, how these contracts are extended, and the ways in which there are opt-outs.
>
> In Italy, there is no minimum wage. What the social partners agree within these collective bargaining contracts becomes, effectively, the floor. The issue is that the floor has been set too high, and these are extended in a way that firms are not able to opt out in practice. An incremental approach would be to enhance the effectiveness of opt-outs or to provide even more of productivity bonuses. But this approach has been tried and has not worked. The implications are continued significant regional labor market differentiation and very high structural unemployment. In practice, going down the route of just strengthening second-tier firm-level bargaining is unlikely to give the results that one would want to have.
>
> Coming back to the recommended reform package, the idea is that the various measures that we have proposed in the staff report—in particular, decentralizing wage bargaining and liberalizing products and service markets—are of very high and urgent priority. Both of them complement each other.
>
> Decentralizing wage bargaining will lower structural unemployment. But liberalizing product markets will increase labor demand. The two of them together imply—and this is exactly the value added of the simulations—that if it done credibly, there is no negative short-term output cost. There would be positive output gains in the short term as well as in the medium term.
>
> In terms of political feasibility, there will be a reallocation of power, in the sense that outsiders will now be able to come in. Those younger generations, those who have been left out as reflected in the high youth unemployment, will be brought into the bargaining process by the

decentralizing of the wage bargaining; whereas, some of the labor unions will lose some power. But to reiterate, the force of the analytical work is that, if implemented credibly and together, the reform package will yield net overall economic benefits in the short term that could be redistributed, if there is an appropriate underlying fiscal mechanism.

The Deputy Director of the Strategy, Policy, and Review Department (Mr. Bayoumi), in response to further questions and comments from Executive Directors, made the following additional statement:

I had interpreted the question originally as being, does the Board endorse working papers if they are referenced, and the answer to that is no. It is like any other reference to outside work.

What was just asked is what is the difference between selected issues papers and working papers. If one does analytic work as background to a staff report, there are two options, and mission chiefs do not follow a prescribed policy on this. One is to issue it as a working paper, the other is to issue it as a selected issues paper. Essentially, the differences are, working papers require more prior planning because it takes longer to get them out and are subject to more internal review in that they are typically sent around to several departments. hence, if anything, the working paper is open to more peer review. In general, there are arguments to do a working paper if one gets the work done early enough.

Mr. Fanizza, in a brief concluding statement, thanked Directors and the staff.

The Acting Chair (Mr. Furusawa) noted that Italy is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They noted that Italy's longstanding structural weaknesses have contributed to a challenging economic situation, including sluggish income growth, elevated unemployment, and high public debt. They welcomed the authorities' focus on supporting growth and improving social outcomes as well as the recent moderation of the 2019 fiscal plans. Directors welcomed the authorities' intention to put high public debt on a firm downward path, in view of the downside risks. They generally noted, however, that the authorities' strategy falls short of comprehensive reforms needed to address the longstanding structural impediments to sustained growth and, therefore, risks leaving the economy vulnerable. They recommended that priority needs to be given to implementing a comprehensive package of structural reforms, growth-friendly and inclusive fiscal consolidation, and further strengthening bank balance sheets.

Directors emphasized that decisive structural reforms to raise productivity and unlock Italy's potential are critical to improve economic outcomes and enhance resilience. In this context, they welcomed the adoption of the new general insolvency framework, the anti-corruption law, and the measures to enhance public investment management, as well as the authorities' intention to cut red tape and simplify administrative procedures. Directors underscored the need to liberalize product and service markets and reduce the size of and uncertainty over dismissal costs. Directors encouraged the authorities to decentralize wage bargaining, although a number of Directors acknowledged potential political economy challenges. They supported implementing these reforms as a comprehensive package that would yield important synergies and reduce structural unemployment as well as raise productivity and investment. Directors also called for further progress in streamlining procurement and reforming local state-owned enterprises.

Directors considered that credible and high-quality fiscal consolidation is key to putting public debt firmly on a downward path and reducing sovereign spreads. They recommended a gradual and balanced adjustment toward a small overall surplus in the medium term. Some Directors concurred with a consolidation pace that is broadly consistent with the preventive arm of the Stability and Growth Pact. Directors emphasized that fiscal adjustment should be underpinned by high-quality measures to promote growth and social inclusion. They underscored the need to protect the poor by means of a modern guaranteed minimum income program, reduce current spending, avoid reversing past pension reforms, and raise public investment. Directors also highlighted the need to broaden the tax base—including by addressing large VAT compliance gaps, rationalizing other tax expenditures, avoiding tax amnesties, prioritizing strict enforcement and introducing a modern property tax on primary residences—and lower the tax wedge on labor.

Directors emphasized that safeguarding public finances is essential to financial sector stability. They welcomed the important progress in reducing non-performing loans, increasing provisions and building capital buffers. Directors noted that weak profitability and sustained high sovereign yields pose challenges to the banking system. They encouraged further strengthening the banking system and also emphasized the importance of continuing to reduce costs and non-performing loans, and strengthening bank governance.

They considered that the consolidation of cooperative banks into three new banking groups should be completed promptly while subjecting all three groups to asset quality reviews. Directors further stressed that swift recapitalization of weaker banks or timely and effective use of the resolution framework is essential to address outstanding weaknesses, and avoid excessive costs to the taxpayers and the rest of the banking system.

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

APPROVAL: April 6, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Macro/Outlook/Risks

1. Could staff elaborate on the underlying factors behind their assessment of a marked decline in labor productivity between 2017 and 2018 (see Table 1 page 32 of the Staff Report; Table 1 page 4 of Supplement 2)?

- In 2017, the real value added in industry grew by 3.4 percent, driven in important part by strong growth in trading partners and significantly outpacing the growth in hours worked or full-time equivalent employment. In 2018, weaker growth in the euro area as well as deteriorating terms of trade have contributed to sharply slower real growth in value added (reaching 0.5 percent in 2018:Q3) that has not yet been reflected in slowing employment growth. As a result, labor productivity growth in 2018 is projected to decline.

2. Are staff able to elaborate on the drivers of the variation across central estimates of the output gap?

- While there are some methodological variations, the key difference relates to judgment on which measures of slack are appropriate. For instance, is the standard unemployment rate with a long-term historical average of about 10 percent through multiple boom-bust cycles the most relevant metric or should estimates focus more on broader measures of unemployment. The latter would allow to capture a large increase in involuntary part-time employment, pointing towards larger available slack compared to standard measures of unemployment. This issue has been discussed in previous IMF publications (see, e.g., 2017 Oct WEO). As noted in the staff report (Box 1), staff favors arguments for greater slack.

3. Could staff elaborate on the main differences behind the staff's growth projections and those of the authorities?

- Following the revision to the 2019 fiscal plan, staff foresees a reduction in the stimulus for 2019 and a postponement of the stimulus into 2020. Correspondingly, staff lowered projected growth in 2019 by 0.2 percentage points and increased projected growth in 2020 by a similar amount. Staff thus projects growth at 0.6 percent 2019 and 0.9 percent in 2020. These are similar to the latest projections published by the Bank of Italy for 2019–20.

- Vis-à-vis the authorities, the main differences relate to: (1) the offsetting effect of the persistent rise in sovereign yields, where staff projects a more negative effect on demand; (2) for 2020–21, staff does not include the impact of the "VAT safeguard clause", which implies a larger fiscal impulse; and (3) staff estimates potential growth to be lower.

4. ***We would appreciate staff's explanation on factors behind Italy's firm level TFP trend.***

- Several studies have explored common factors underlying weak productivity growth across advanced economies. These include reduced innovation at the technological frontier (Gordon (2012)), a slowdown in the adoption of technologies by lagging firms (Andrews et al. (2015)), and credit-supply shocks restricting investment in research and development (e.g. Aghion et al. (2012); Manaresi and Pierri (2018)) or distorting the adjustment of firms' desired labor and capital allocations (e.g. Doerr et al. (2018)).
- More specifically, Andrews et al (2017) and OECD (2017) show that while in the OECD on average productivity growth of firms at the technological frontier has far outpaced non-frontier firms, productivity growth of Italian manufacturing frontier firms has been declining and doing so even faster than in other Italian firms. Andrews and Cingano (2014) calculate that approximately three-quarters of the productivity gap between global and national frontier firms can be attributed to the small size of national firms.
- In this regard, several papers have also highlighted institutional frameworks, e.g., product, service and labor market regulations and the prevalence of "familism" and "cronyism", as factors weighing specifically on the productivity growth of Italian firms (e.g. Pellegrino and Zingales (2017)). Anderson and Raissi (2018) find that firms' TFP growth in Italy is adversely affected by the build-up of corporate debt.

5. We would appreciate staff's advice on the potential macro-financial spillovers of a no-deal Brexit outcome as they might apply to Italy.

The UK is the fourth most important export destination for Italy, accounting for a share of 5 percent of total exports in 2017. Italy has a trade surplus of about USD 13 billion vis-à-vis the UK. A no-deal Brexit could disrupt transport and trade flows—especially in perishable goods such as agricultural or pharmaceutical products—until sufficient custom capacity is put in place. The intermediation by UK entities of Italian sovereign bonds could also be disrupted and costs could increase. Knock-on effects of increased global financial uncertainty and risk aversion could further impact Italian asset valuations and bank balance sheets. Also, banks would only be able to issue "bail-in-able" liabilities under British law if contractual clauses are added for holders to recognize the resolution powers of the Single Resolution

Board (SRB) in case of a bank failure. For the existing stock of MRELs issued under English law, the SRB will consider each situation on a case-by-case basis.

- A recent IMF SIP (https://www.imf.org/en/Publications/CR/Issues/2018/07/18/Euro-Area-Policies-Selected-Issues-46097) provides a range of estimates on the impact of Brexit under different hypothetical scenarios. It estimates the output loss for Italy of reverting to WTO trade rules, the worst-case scenario, at around 0.2 percent of GDP.

Fiscal Policy

6. ***Has staff assessed the fiscal stance entailed by the recently adopted 2019 budget, which resulted from a compromise with the European Commission?***

- The fiscal stance is modestly expansionary in 2019. Staff estimates a relaxation of the structural primary balance of 0.3 percent of potential GDP.
- For 2020–21, staff projects a notably more expansionary fiscal stance, with a relaxation of the structural primary balance of about 0.8 percent of potential GDP, unless there is broad political support to activate the "VAT safeguard clause" or find compensatory measures that has been difficult to do in the past. This is also reflected in staff's projected overall deficit rising to about 3 percent of GDP.

7. ***Could staff elaborate on the implications of the recent revisions in the fiscal stimulus plan on the debt sustainability assessment, including the general path of the public debt-to-GDP ratio? It would be helpful if staff could also elaborate further on the drivers behind the differences between this year and last year's debt sustainability analysis.***

- Under staff's baseline scenario, public debt would remain very high at about 131 percent of GDP and vulnerable to adverse shocks. Staff projects the public debt-to-GDP ratio to reach 131.1 percent in 2021, as compared to the authorities' projected 128.2 percent. The DSA analysis in the staff report remains unchanged because the authorities' measures were already in the staff report DSA analysis although the numbers for 2019–20 changed slightly following the finalization of the 2019 budget. The tables corresponding to the slight revisions in the macroeconomic numbers presented in the staff supplement are below.
- The main differences in DSA assumptions between 2018 and 2017 relate to safeguard clauses (that are not included in projections this year); and the incorporation of staff estimates of higher pension spending in debt-to-GDP in this year's DSA.

Italy Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

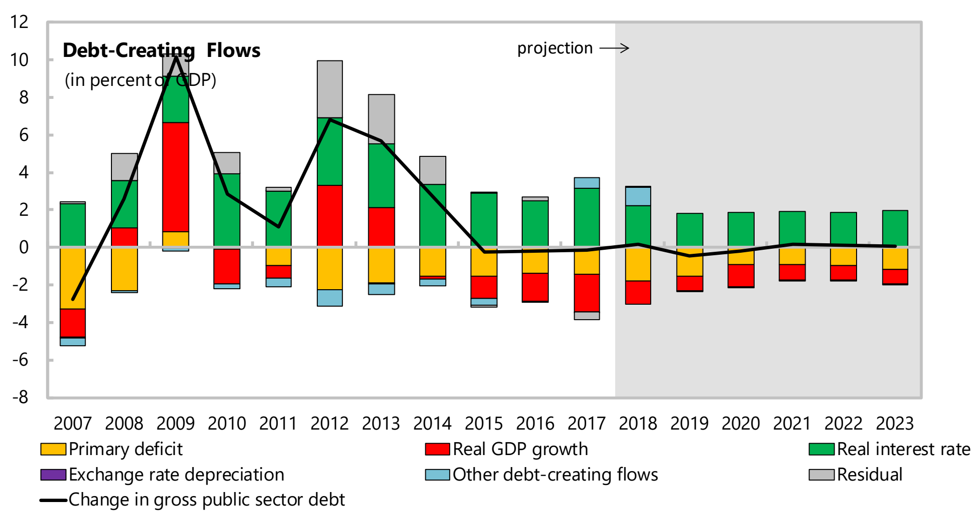
Debt, Economic and Market Indicators [1]

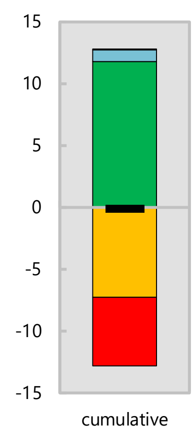
	Actual			Projections					
	2007-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	118.0	131.4	131.2	131.4	130.9	130.7	130.9	131.0	131.1
Public gross financing needs	28.5	23.8	24.9	22.4	23.2	23.2	23.7	25.1	26.4
Net public debt	107.5	118.9	119.0	119.4	119.2	119.3	119.7	120.1	120.4
Real GDP growth (in percent)	-0.7	1.1	1.6	1.0	0.6	0.9	0.7	0.6	0.6
Inflation (GDP deflator, in percent)	1.5	1.1	0.5	1.1	1.5	1.5	1.6	1.7	1.7
Nominal GDP growth (in percent)	0.7	2.3	2.1	2.1	2.1	2.4	2.2	2.3	2.3
Effective interest rate (in percent) [4]	4.1	3.1	3.0	2.8	2.9	3.0	3.1	3.1	3.3

As of January 16, 2019		
Sovereign Spreads		
EMBIG (bp) 3/		253
5Y CDS (bp)		214
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB	BBB
Fitch	BBB	BBB

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	3.2	-0.2	-0.1	0.2	-0.5	-0.2	0.2	0.1	0.1	-0.1	
Identified debt-creating flows	2.0	-0.4	0.3	0.2	-0.5	-0.2	0.2	0.1	0.1	-0.1	
Primary deficit	-1.5	-1.4	-1.4	-1.8	-1.5	-0.9	-0.9	-1.0	-1.2	-7.3	1.2
Primary (noninterest) revenue and gra	46.6	46.5	46.4	46.2	46.3	46.3	46.3	46.3	46.4	277.8	
Primary (noninterest) expenditure	45.1	45.1	44.9	44.4	44.8	45.4	45.4	45.3	45.2	270.6	
Automatic debt dynamics [5]	3.8	1.0	1.1	1.0	1.1	0.7	1.1	1.1	1.2	6.2	
Interest rate/growth differential [6]	3.8	1.0	1.1	1.0	1.1	0.7	1.1	1.1	1.2	6.2	
Of which: real interest rate	3.0	2.5	3.1	2.3	1.8	1.9	1.9	1.9	2.0	11.8	
Of which: real GDP growth	0.8	-1.5	-2.0	-1.3	-0.8	-1.2	-0.8	-0.8	-0.7	-5.6	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.4	-0.1	0.6	1.0	0.0	0.0	0.0	0.0	0.0	1.0	
Privatization Receipts (negative)	-0.2	-0.1	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt flows (incl. ESM and Euro	-0.2	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	1.0	
Residual, including asset changes [8]	1.2	0.2	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	





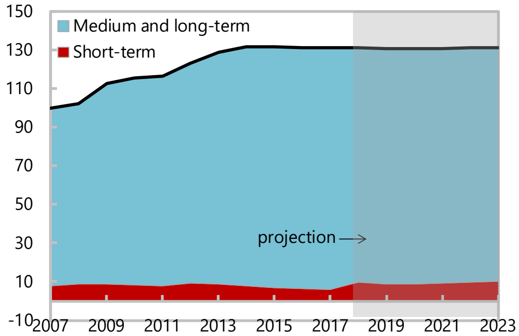
Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Italy Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

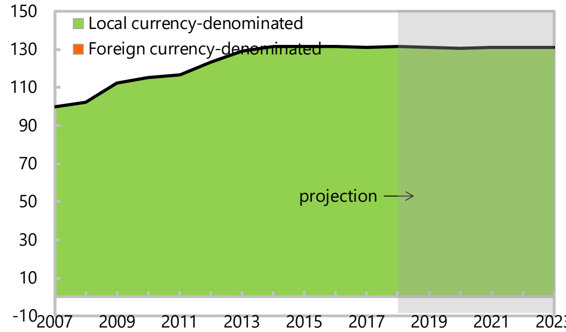
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

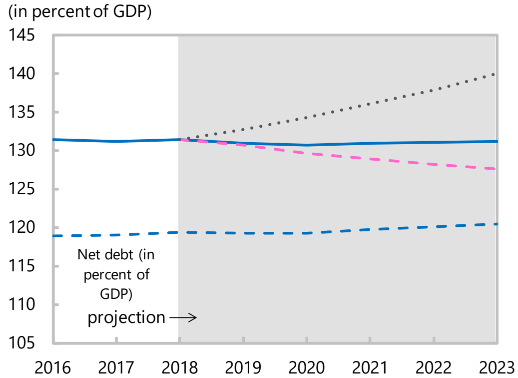


Alternative Scenarios

Baseline Historical Constant Primary Balance

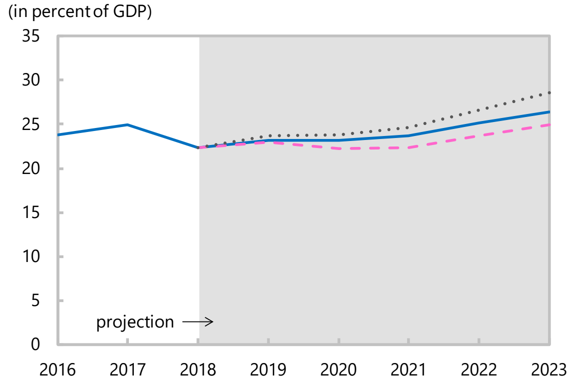
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

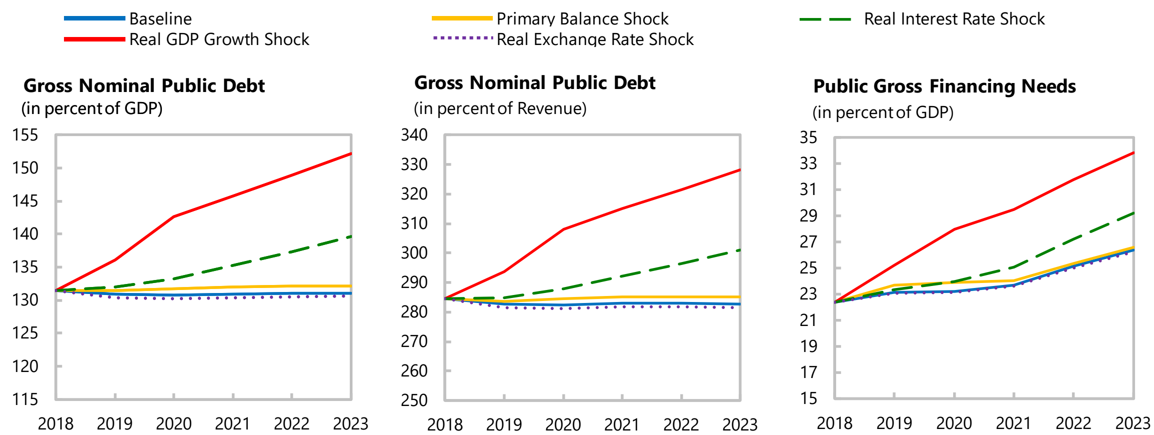
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	0.6	0.9	0.7	0.6	0.6
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.5	0.9	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3
Constant Primary Balance Scenario						
Real GDP growth	1.0	0.6	0.9	0.7	0.6	0.6
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.8	1.8	1.8	1.8	1.8
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary Balance	1.8	1.3	1.3	1.3	1.3	1.3
Effective interest rate	2.8	2.9	3.1	3.3	3.5	3.7

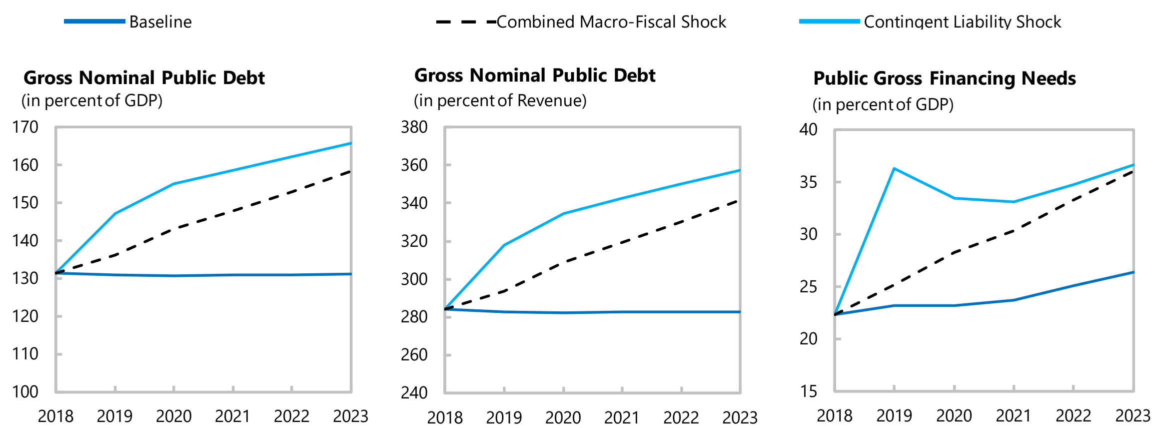
Source: IMF staff.

Italy Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	0.6	0.9	0.7	0.6	0.6
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary balance	1.8	1.0	0.4	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.2	3.3
Real Interest Rate Shock						
Real GDP growth	1.0	-0.2	0.1	-0.2	-0.2	-0.2
Inflation	1.1	1.5	1.5	1.6	1.7	1.7
Primary balance	1.8	1.5	0.9	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.3	3.5	3.8	4.0
Combined Shock						
Real GDP growth	1.0	-1.7	-1.4	-0.2	-0.2	-0.2
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	0.2	-1.8	-1.8	-1.7	-1.5
Effective interest rate	2.8	2.9	3.3	3.6	3.8	4.1

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	1.0	-1.7	-1.4	0.7	0.6	0.6
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	0.2	-1.8	-1.8	-1.7	-1.5
Effective interest rate	2.8	2.9	3.0	3.2	3.3	3.5
Real Exchange Rate Shock						
Real GDP growth	1.0	0.6	0.9	0.7	0.6	0.6
Inflation	1.1	1.9	1.5	1.6	1.7	1.7
Primary balance	1.8	1.5	0.9	0.9	1.0	1.2
Effective interest rate	2.8	2.9	3.0	3.1	3.1	3.3
Contingent Liability Shock						
Real GDP growth	1.0	-1.7	-1.4	0.7	0.6	0.6
Inflation	1.1	0.9	0.9	1.6	1.7	1.7
Primary balance	1.8	-10.7	0.9	0.9	1.0	1.2
Effective interest rate	2.8	3.0	3.6	3.5	3.5	3.5

Source: IMF staff.

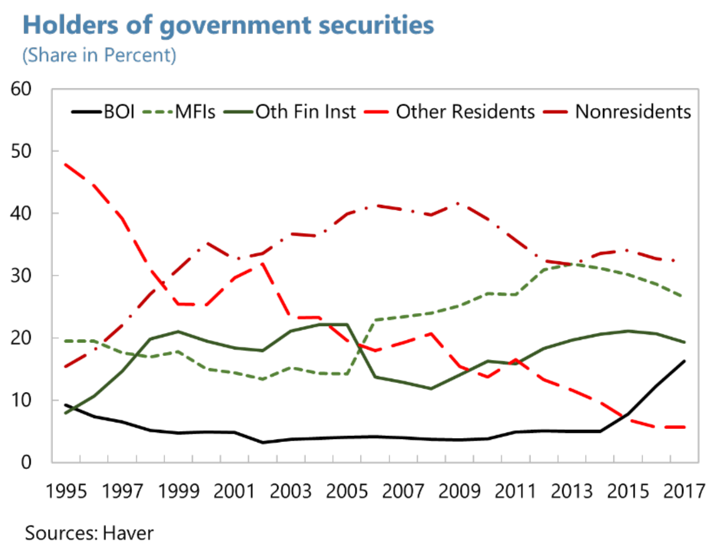
7. ***Could staff comment on how the authorities' slightly higher growth assumptions for 2019-20 – as outlined in the buff statement – would impact the DSA projections under the baseline?***

- The authorities project real GDP growth of 1 percent in 2019 and 1.1 percent in 2020, while staff projects real GDP growth of 0.6 and 0.9 percent in 2019 and 2020, respectively. The authorities' slightly higher growth projections would lower the debt-to-GDP ratio slightly in 2019-20, while still remaining above 130 percent of GDP. Over the medium-to-longer term, there is no change in staff's DSA projections.

8. Could staff elaborate on the possible implications of the end of the ECB's net purchase program of public debt?

- Italy has been a major beneficiary of the quantitative easing (QE) program. Since March 2015, the Eurosystem's net purchases of Italian public debt in the secondary market exceeded €360 billion, compared to gross medium- to long-term bond issuances (on the primary market) of about €600 billion.

- With the end of the program, private sector will need to step in to buy sovereign debt. Given the holding structure of Italy's public debt, starting January 2019 the market would need to finance about 95 percent of Italy's annual gross financing needs of above 20 percent of GDP. This in turn could put upward pressure on sovereign yields. It could also crowd out resources for private investment.



9. How critical is redenomination risk and not just fiscal policy risk?

- As noted in Figure 5 of the staff report, the tail risk of redenomination reappeared in the past year and has contributed to a widening of spreads. In the last month, the spread between the Italy ISDA 2014 and 2003 CDS contracts has declined somewhat but remains elevated.

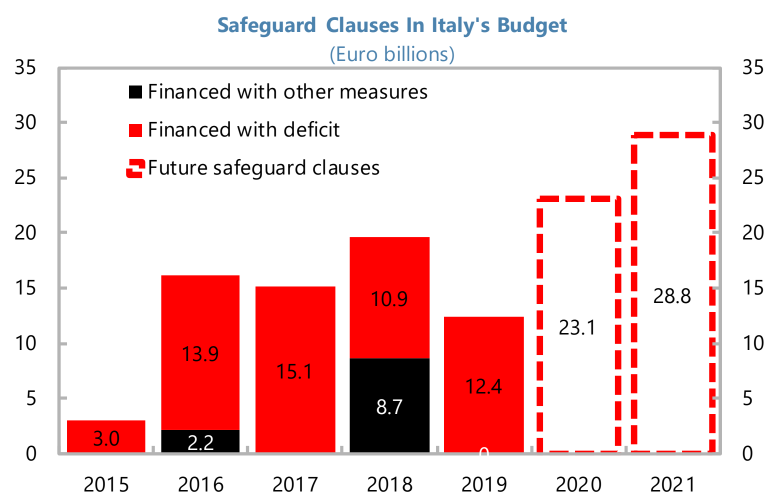
- The authorities have repeatedly and emphatically noted their commitment to euro membership. Correspondingly, discussions focused on overall policies, including fiscal policies, consistent with this commitment.

10. *Could staff elaborate on the decision to choose for "limited fiscal space" instead of "no fiscal space"?*

- The category of "no fiscal space" applies for "cases where fiscal sustainability and market financing are patently in question, or market financing is already prohibitively expensive." Where "there are clear, but not imminent risks to fiscal sustainability" assessing fiscal space as "at risk" would be appropriate, which is staff's assessment.

11. *Could staff elaborate on the experience and requirements for activation of the VAT safeguard clause?*

- Since the euro area confidence crisis, the authorities have legislated safeguard clauses to signal commitment to improving deficit targets. In practice, however, it has not been activated since 2014 (see chart below). For the most part, the deficit target was adjusted.
- The amount of safeguard clauses has increased over time and are higher for 2020–21 than for previous years, amounting to about €23–29 billion, respectively (about 1.3 and 1.6 percent of GDP). It implies that the standard VAT rate would increase from the current 22 percent to 25.2 percent in 2020 and 26.5 percent in 2021. To activate the clause, current legislation would simply be implemented rather than cancelled as has been done in the past.



12. *What are the expected contributions of a comprehensive reform of tax system to improving the country's fiscal position both by policy reform and that of tax administration?*

- A comprehensive reform of the tax system is needed to broaden the tax base, lower the tax wedge on labor, promote efficiency, and support fairness. Large VAT compliance and policy gaps need to be addressed, tax expenditures rationalized, a modern property tax introduced on primary residences, and stricter enforcement prioritized. Tax amnesties should be avoided.

- By reducing the fiscal cost of sizeable tax expenditures and compliance gap, fiscal consolidation needs in Italy could be addressed without the need to increase VAT rates, as currently envisaged in the government's budget for 2020-21 (i.e., the activation of the safeguard clause).

13. While taking note of the authorities' citizenship income program, we would like staff to further elaborate on this measure and its expected effects.

- The citizenship income program is primarily aimed at assisting the poor and facilitating their integration into the labor market.
- However, benefits are very high, set at 100 percent of the relative poverty line for tenants without income, compared to international good practice of 40–70 percent. The benefits are relatively more generous in the South, where the cost of living is lower. The implications are correspondingly larger disincentives to work as well as risks of welfare dependency.
- Moreover, although benefits are targeted to the poor, added benefits decline too quickly with family size (penalizing poor larger families) while pensioners are treated preferentially.
- Adequate controls will be essential for effective targeting. Conditioning on active labor market policies will also be important in this regard (see further below on these policies).

14. Could staff provide an estimate of the budgetary costs of the changes to the retirement rules and the adoption of the citizenship income program? How would they alter the debt sustainability calculations?

The introduction of the planned pension reversal and the citizenship income program is projected to raise the fiscal deficit by 0.5 percent of GDP in 2019 and about 0.9 percent of GDP in 2020–21. The fiscal cost in 2019 is lower because introduction of these policies was delayed by a few months.

- The direct costs of the citizenship income program and of higher pension spending (arising from the partial reversal of past pension reforms) are included in the baseline medium-term deficit and debt projections. Under the baseline scenario, and unless there is broad political support to activate the VAT safeguard clause or find compensatory measures, public debt would remain very high at about 131 percent of GDP and vulnerable to adverse shocks.

15. Have staff and the authorities discussed the benefits of conducting a fiscal transparency evaluation, as it was done in several other advanced European economies, including the U.K., Austria, Portugal, Finland, and Ireland?

- Staff of the Fiscal Affairs Department stand ready to conduct a fiscal transparency evaluation in Italy at the request of the authorities. The benefits of conducting such an evaluation were discussed with the Italian authorities in previous years but no formal request was made.

Structural Policies

16. Could staff briefly clarify the prioritization of proposed reforms to take advantage of possible synergies across measures and help ensure an orderly reform process?

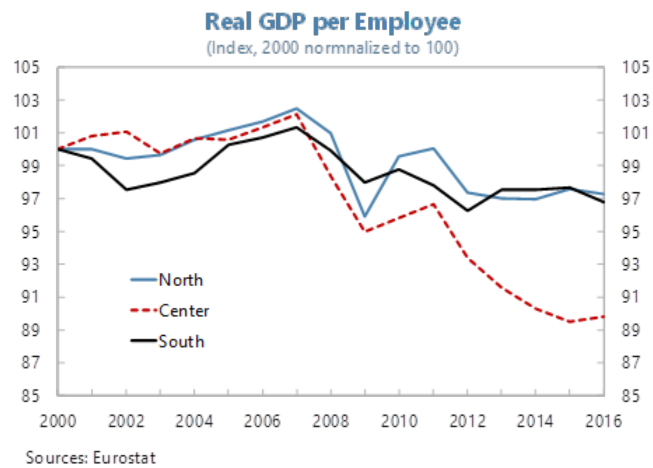
- Staff sees the reforms highlighted in the report as a package: they mutually reinforce and complement one another, enhancing their overall impact. Some reforms would ideally be implemented quickly and upfront, such as liberalizing product and service markets and decentralizing wage bargaining. The former has been shown to yield both near-term and longer-term growth dividends. Together, these two reforms would boost competitiveness, growth, and employment. Continued efforts to restructure banks would also facilitate the flow of credit to new investment. By comparison, public administration and judicial reform require sustained and strong implementation over many years and would be expected to yield benefits gradually over time.
- Concurrent growth-friendly fiscal consolidation in a credible, gradual and balanced manner as recommended in the report would support growth and social inclusion.

17. The authorities note their view that the current system of two-tier bargaining sufficiently links wages with productivity given performance-linked bonuses. This view is hard to reconcile with staff's finding that a 30 percent labor unit cost gap has accumulated between Italy and the rest of the euro area over the past two decades. Could staff shed more light on the divergence in views?

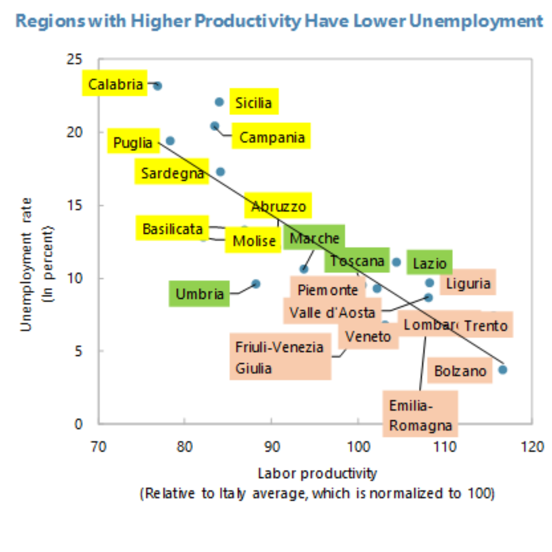
- The coverage of the single sectoral national wage contract in practice is very high—exceeding 90 percent—owing to constitutionally-provided administrative extension to the entire workforce, whether covered by unions or not. As a result, the bargained wages are effectively binding. Survey evidence presented in D'Amuri and Giorgiantonio (2015) reveals that the portion of wages exceeding the minima in national collective agreements is only around 10½ percent. Thus, in practice, the wage distribution is highly compressed and productivity-linked bonuses have not allowed for adequate differentiation across the distribution, even though regional firm-level productivity differentials are pervasive and the supply-demand mismatch of skills is one of the largest in Europe (see, e.g., OECD, 2017).

18. Could staff elaborate on the regional differences in productivity, unemployment rates, and informality between the north and the south?

- The chart below shows the trend in labor productivity from 2000 to 2016 (the latest year that regional data are available). The data are normalized to 100 in the year 2000. Across Italian regions, labor productivity has steadily declined (and lagged euro area partners, falling behind both in the pre-crisis period and since the crisis). In the pre-crisis period, labor productivity in the north was somewhat better than the south. Since the crisis, labor productivity has declined in the north and the south.



- The chart below is a cross-section of labor productivity vs. unemployment across provinces within Italy. The yellow shaded labels indicate southern provinces, the green ones central provinces, and the beige ones northern provinces. In level terms, labor productivity is higher in the north than in the south. But given the Italian wage bargaining system where wage levels within a sector are similar across the country, the outcome is that more productive provinces (the north) have lower unemployment rates than less productive provinces (the south). Unemployment in the northern regions is about 6 percent, whereas unemployment in the southern regions is near 20 percent.



- The informal economy is estimated at about 12-18 percent of Italy's GDP, depending on the methodology used and the years covered. Informal activities have historically been higher in Southern regions and lower in the Northern areas. The agriculture sector accounts for a quarter of all informal employment, contributing to high informality levels in the south, the country's main agricultural area. Moreover, higher unemployment has been associated with greater informality (Boeri and Garibaldi (2002) and Di Caro and Nicotra (2014)).

19. We appreciate staff's comments on the capacity of local administrators to implement the active labor market programs as envisioned in the Jobs Act.

- Active labor market policies in Italy have been characterized by regional fragmentation, lack of national coordination, and differences in capacities across regions. The creation of the national employment agency (ANPAL) in the Jobs Act of 2014 aimed at coordinating employment services including by harmonizing active labor market policies across regions. However, this entity is today not fully operational. This has significantly reduced the scope for an equal implementation of active labor market policies across the regions of Italy.

20. The staff report indicates that the authorities are interested in preparing a new competition law. We would appreciate staff's update on the authorities' plan to prepare a new competition law and on specific measures to address previous shortfalls.

- Although the authorities have said that they would like to introduce a new competition law, no timeline, measures or specific areas of focus have yet been specified.

21. ***We welcome the recent overhaul of the insolvency and bankruptcy frameworks and would appreciate to hear staff views on their key features. It is not clear from the buff if the special insolvency regime for large enterprises—discussed in Staff Working Paper issued recently and the Staff Report—was folded into the adopted framework.***

- The new law makes more coherent the insolvency framework, which over time became extremely complex. The new law—which is yet to be published—appears to incorporate best practices and recent trends in European insolvency regimes. Its mains features include: 1) early detection of debt distress and encouraging debt restructuring agreements between debtors and creditors in order to avoid lengthy insolvency procedures; 2) increasing incentives for reorganization of businesses; 3) simplifying insolvency procedures and making liquidation a last resort measure; 4) regulation of the insolvency of corporate groups; 5) strengthening the role of insolvency professionals and their professional standards; and 6) facilitation of personal insolvency procedures.

- The new insolvency regime does not, however, incorporate the special regime for large enterprises which has remained outside of the scope of the reform.

22. ***What would be the growth effects in Italy if the authorities were able to move from the country's current 54th place in the Corruption Perception Index ranking to the average of other G-7 members, which is close to the 14th place?***

- The April 2018 Board paper on the new framework for enhanced engagement on governance found that a one-quartile improvement in corruption indices is associated with roughly a 1/3 percentage point improvement in per-capita GDP growth in advanced economies, based on a meta-analysis of published studies (Table A2.2). Using this estimate and the 2017 scores for control of corruption in the *Worldwide Governance Indicators* implies that an improvement in Italy's corruption perceptions to the average of other G-7 countries would be associated with an increase in annual per capita GDP growth of 0.4 percentage points. Some other methodologies discussed in the Board paper (e.g., panel data results in Annex 3) yield somewhat larger estimates. While there are significant uncertainties around any specific point estimate given methodological uncertainties and difficulties in identifying causality, the broad finding of large and positive growth effects from reducing corruption is robust, as discussed in the April 2018 Board paper.
Taking into account the Italian authorities' efforts to collaborate with the Doing Business project and even leading the EU efforts in this area, we would like staff to clarify the authorities' position mentioned in paragraph 29.

- The authorities mentioned that respondents needed to enter information in a specific way and local authorities needed to implement specific measures, yet many regional governments usually do not fill in the survey properly or do not understand it. The authorities added that Doing Business criteria could in theory be met while, in practice, measures might not be binding, used properly, or be the right instruments to address an underlying structural issue.

Macro-financial

- In view of the bail-in challenges faced by banks in the past, could staff comment on the types of bail-in instruments that could be considered more suitable in future?

- The bail-in challenges faced by banks in the past were not due to the type of instrument (subordinated debt), but with the type of investor it was issued to, namely, retail customers. The Single Resolution Board has also highlighted the problems of households holding bail-in-able debt when it comes to effective bank resolution.

23. Could staff elaborate on the next steps the authorities intend to take in the case of Banca Carige? Could staff elaborate further on the appropriateness of the strategy being implemented to deal with Banca Carige?

- It was appropriate for the banking supervisor to intervene and appoint temporary administrators to Banca Carige owing to increasing solvency and liquidity concerns. The government subsequently took the step of issuing an emergency decree preemptively if the bank would urgently need solvency or liquidity support. The administrators and the authorities have yet to identify and announce a solution for the bank; it could entail a merger with another bank or a precautionary recapitalization. Given that key decisions and details remain outstanding, staff is not able to comment further at this juncture. That said, swift recapitalization of problem banks or the timely and effective use of the resolution framework is essential to avoid weaknesses from lingering, excessively burdening taxpayers and the rest of the system, and threatening stability.

24. Noting that SSM's thematic review identified no systemic issues for Italian banks but rather found considerable opportunities for individual banks to improve their business models and processes, we invite staff to elaborate more on the SSM's review and share staff's view on their recommendations.

- In 2016, the European banking supervisors launched a thematic review to assess in more depth the profitability drivers and business models of "significant" institutions (i.e., those supervised directly by the SSM). As the review was cross-cutting or horizontal in nature, it did not have a country-specific focus. The ensuing report produced broad findings and recommendations that will be applied to the supervision of individual banks but were not specific to Italian banks.

25. Can staff provide some policy suggestions, including macroprudential tools to moderate this sovereign-bank link?

- Several issues related to banks' own-sovereign holdings (or so-called "home-bias") are being investigated at the BIS (to get a global agreement) and also at the EU level. Setting large exposure limits on domestic sovereign exposures or capital surcharges on asset concentration or imposing non-zero risk weights are examples of possible policy tools.

- However, these would need to be considered in the broader context, including potential reallocation of bank sovereign exposures across the banking system; interactions with other rules of the Basel framework, including on liquidity, the effects on the functioning of sovereign debt markets and on governments' financing conditions; and the impact on other financial market segments.

- In the Euro Area, this discussion of regulating sovereign exposure of banks is also tied to the discussion of a common deposit insurance scheme in the Banking Union, with some member states asking for much lower sovereign holdings before they would support a common deposit insurance scheme.

26. While staff note that there has been little pass through of elevated spreads to real economy lending rates to date, have they seen any other signs of credit tightening, for example in surveys of borrowers, collateral requirements or other quantity restrictions?

- Elevated sovereign spreads have adversely impacted banks' costs of tapping wholesale markets as well as bank valuations. Evidence of passthrough to the rest of the economy remains limited so far. The latest Bank Lending Survey conducted by the Bank of Italy shows modestly tighter lending standards in 2018:Q4 for firms and households after a period of easing. Banks have also reported small increases in interest rates on new lending to households. As for credit, lending to non-financial corporations decelerated for a second consecutive month in November 2018 to 1.1 percent y/y growth. Lending to households, however, increased at a broadly stable pace by 2.7 percent y/y growth.

27. Asset quality has improved as efforts to address the legacy stock of nonperforming loans (NPLs) on banks' balance sheets are bearing fruit, and the number of new NPLs has declined close to pre-crisis levels. We wonder how critical a role was played by secondary markets on this development.

- Most NPL transactions have been in the primary market. With NPL sales being a recent phenomenon in Italy, the secondary market is in its early stages of development. In 2018, to staff's knowledge, four secondary market transactions were recorded amounting to about €1 billion. This compares to about 50 transactions for a total of circa €70 billion in the primary market.