2014 Article IV Consultation with Italy Concluding Statement of the IMF Mission[1]

June 17, 2014

UNBLOCKING ITALY'S GROWTH POTENTIAL

"Ours is a rusty country, a country bogged down, chained by stifling bureaucracy, by rules, regulations and codes…." Prime Minister Matteo Renzi, February 2014

A Fragile Recovery Emphasizes The Urgency of Continued Reform

The economy is struggling to emerge from its deep recession. Steady exports and a pickup in private consumption are offsetting the stiff headwinds to investment from tight credit conditions, especially for small firms. The large economic slack has contributed to pushing down inflation to well below one percent, increasing the real burden on debtors.

Growth is forecast to pickup this year, supported by exports and a gradual easing of financial conditions. However, the recovery remains fragile and unemployment unacceptably high, highlighting the need for bold and quick policy actions. Deep structural changes are needed to make Italy a more dynamic country that adapts quickly to a changing world and is home to innovative entrepreneurs. Labor markets, competition policy, small and medium enterprises (SMEs), and the judicial system are four connected areas where reforms would unlock significant growth potential. Fiscal rebalancing to allow lower tax rates and increased productive spending can also lift activity.

Prime Minister Renzi has outlined an ambitious agenda to reform the electoral law, the labor market, judicial system, and public sector. The passage of the *delega fiscale* provides a welcome framework for simplifying and improving the tax system. The government's recent announcement builds on this agenda with measures to reform the public administration, support the corporate sector, and reduce corruption. Delivery of real change is now crucial for strengthening confidence and support for reforms. Building on this agenda, the mission sees the following areas as priorities to unblocking Italy's productivity and growth potential.

I. Structural Reforms to Boost Jobs and Investment

Labor reforms. The Jobs Act outlines a number of useful proposals to boost participation and address duality. Translating these ideas into concrete actions will strengthen incentives to hire and invest in workers. In particular, a contract with gradually increasing protection would increase fairness by reducing duality, especially if it were to replace existing open-ended contracts. Raising the quality of active labor market policies to the level of the best regions, with centralized monitoring, would help match jobs and workers and address the long-term unemployment problem. To allow firms to adapt more quickly to changing economic conditions, Italy should promote more firm-level wage bargaining, together with greater flexibility in national contracts. Differentiation of public wages across regions could also assist in improving the wages-productivity link in the private sector.

Judicial efficiency. Italy has made progress in reducing the large number of pending court cases, but with more than a thousand days still needed to enforce a contract, a more efficient judicial system is urgently needed to promote growth, jobs, and credit. Building on recent reforms, consideration could be given to reviewing court fees, limiting excessive appeals, developing performance indicators for all courts, and incentivizing the use of mediation.

Disseminating regional best practices (such as the so-called "Strasbourg Program" in the Turin Court) could help reduce the performance gap.
Competition policy. Legislative initiatives have been put forward over the years to remove regulatory barriers in many markets, but implementation has been weak. Delivering on the commitment to legislate recommendations of the antitrust authority by September 2014 would be an important first step to enhancing competition, encouraging new entrants, and lowering the cost of services.
SME growth and dynamism. SMEs are the backbone of the Italian economy. But, they are more leveraged and there are fewer start-ups than elsewhere in the euro area. In recent years, the Italian insolvency regime has been transformed to allow faster and more comprehensive restructuring. Encouraging greater use of the insolvency regime and out-of-court workouts would assist viable but distressed firms and provide a "fresh start" for new productive ventures. Reorienting public support to startups could promote the development of new growth sectors. Efficient collateral enforcement mechanisms that do not rely on court decisions could expand the availability and lower the cost of credit. To enhance the legal framework for secured lending, for instance a new loan contract based on fiduciary arrangements could allow quick and efficient enforcement in the event of default.
Fighting corruption will improve the business environment and growth. The 2012 anti-corruption legislation is a step in the right direction and lays the foundation for effective anti-corruption activities. Recent measures approved by the government to provide greater powers to the national anti-corruption authority (ANAC) are welcome. The legal framework could be further improved, notably by criminalizing the false accounting offense and changing the limitation period provisions.

II. A Financial Sector that Supports New Lending and Investment

Bank of Italy inspections have helped improve provisioning coverage ratios and strengthen confidence. In turn, Italian banks have made progress in recognizing losses, disposing of non-performing loans (NPLs), reforming their governance, and are raising significant private capital. But NPLs continue to rise, reaching a record level of 16 percent of loans, as the slow pace of write-offs has not kept up with the inflow of new bad loans. The ECB's comprehensive balance sheet assessment will strengthen confidence and help address financial fragmentation. This should be complemented at the national level by a greater push to clean up bad loans, which would free up resources and support new lending in the recovery:

- *Encourage provisioning and write-offs*. As tried in other countries, higher capital charges or time-limits for writing-off NPLs would encourage faster disposal of bad assets. Harmonizing loan provisioning and encouraging stronger capital buffers would provide incentives for banks to be more pro-active in addressing problem loans. For SMEs, establishing standard criteria for assessing SME loans and guidelines for restructuring viable, but distressed firms could accelerate the use of the workout and insolvency systems.
- *Develop the distressed debt market*. Encouragingly, banks are exploring market-based solutions for NPL management and disposal. An active NPL market would provide an alternative to lengthy bankruptcy, boost loan values, and reduce the corporate debt overhang. To help banks to establish private NPL asset management companies (AMCs), the regulatory measures above or tax incentives could be considered, while ensuring bad assets are transferred at fair market value. Supervisors could play a useful role in encouraging banks to pool their resources for debt workouts and overcoming coordination difficulties.

• *Strengthen corporate governance*. Foundations controlling banks should be required to publish audited accounts, limit their leverage, and follow proper governance rules. Building on recent progress in reducing foundations' ownership of banks, over time, foundations should be encouraged to give up de facto control over banks. The largest cooperative banks should also be encouraged to convert to joint stock companies and consolidate as a way to achieve synergies.

Further developing the capital markets, in particular equity markets, would help reduce reliance on bank credit and support equity investment in Italian corporates. Promoting the professional management of pension funds, while ensuring adequate safeguards are put in place, would enhance investor interest in higher risk/reward opportunities. Over time, reducing the gap between the taxation of public and private securities would encourage more investment in the capital markets.

III. Fiscal Policy that Supports Growth and Stability

Following several years of difficult adjustment, Italy has achieved one of the highest primary surpluses in the euro area—a key factor in strengthening confidence. However, more needs to be done to bring down the high level of public debt and strengthen the resilience of public finances.

In the short-term, fiscal policy needs to strike a delicate balance between setting the debt ratio on a downward path while avoiding excessive tightening that derails the fragile recovery. Conditional on the recovery taking hold, a modest structural surplus next year would be appropriate to bring down debt faster—this would be best achieved smoothly to avoid large adjustment. Privatization efforts should be completed quickly. To support the economy, the priority should be to pursue growth-friendly fiscal rebalancing by:

• *Lowering tax burden*. Greater savings from the spending review and lower tax expenditures would allow reductions of labor taxes to be expanded and made permanent, and permit higher allowance for corporate equity returns (ACE) to stimulate investment. Stronger efforts to curb tax evasion would free up more savings for rebalancing and raise the fairness of fiscal adjustment.

• *More productive spending*. The pension reforms of 2011 have strengthened sustainability. Nevertheless, Italy's public spending has one of the highest elderly biases and lowest levels of education spending in the euro area. In the near-term, shifting resources from the highest earning pensioners towards education and active labor market policies would strengthen productivity and youth employment and help address the large inter-generational imbalance.

A permanent spending review process provides an opportunity to reorient budget priorities towards growth and improve public sector efficiency and effectiveness. The budget formulation process should utilize more fully the existing large body of performance information and be linked closely to a medium term expenditure framework. Reducing overlaps in policy areas that are common to various levels of government and implementation of "standard costs" for deciding transfers to sub-national governments would help address regional inefficiencies in spending. The newly created Parliamentary Budget Office will play an important role in providing clear, independent, public evaluation of the fiscal stance.

IV. European Policies

Policies at the European level could also support growth by easing monetary conditions and reducing financial fragmentation. Recent ECB actions will help in that regard, while faster progress towards the banking union and implementation of the Services Directive will support Italy's own reform efforts. Italy needs to play its part in the EU process, for example by completing arrangements for resolution and backstopping in advance of the ECB assessment.

---

[1] An IMF team visited Italy from June 5-17, 2014, for the annual evaluation of the economy as part of the regular consultations under Article IV of the IMF's Articles of Agreement. This statement describes the preliminary findings of the staff.