IMF Country Reports 23/273

Italy: 2023 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Italy

INTERNATIONAL MONETARY FUND

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IMF Country Report No. 23/273

ITALY

July 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ITALY

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Italy, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 20, 2023, consideration of the staff report that concluded the Article IV consultation with Italy.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 20, 2023, following discussions that ended on May 23, 2023, with the officials of Italy on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 5, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Italy.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR23/273

IMF Executive Board Concludes 2023 Article IV Consultation with Italy

FOR IMMEDIATE RELEASE

Washington, DC – **July 26, 2023:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Italy.

The Italian economy has weathered well the effects of Russia's war in Ukraine, growing by 3.7 percent in 2022. Private consumption rose robustly on recovery in employment, buoyant tourism, and extensive fiscal support of real purchasing power. Growth in services and construction offset weakness in manufacturing, especially in energy-intensive industries affected by high energy prices. Consumer prices increased, largely on surging energy prices, financial conditions tightened considerably and yields on Italian government bonds have risen as monetary policy tightened. The labor market performed strongly, nominal wages have risen but real wages fell. Banks' capital and liquidity buffers remained broadly stable at comfortable levels and NPLs declined further, but risks remain elevated amid the uncertain outlook for the economy and the future path of monetary policy. Extensive policy support and rising interest costs kept fiscal deficits very high. The public debt ratio declined but remains very high. A declining working-age population could lower growth over the longer term.

Growth is expected to enter a slower phase and downside risks dominate the outlook. Growth is forecast to moderate to 1.1 percent in 2023 and to 0.9 percent in 2024, and then to pick up temporarily to 1.1 percent in 2025. Headline inflation is projected to decline steeply to 5.2 percent in 2023 and to 2.5 percent in 2024, driven by lower energy and food prices. A sharper tightening of monetary policy could transmit asymmetrically to Italy and further raise borrowing costs while renewed global financial stress could reduce funding availability, causing public and private spending to retrench and reviving concerns about sovereign-bank-corporate linkages. Policies that slow public debt reduction or prolonged delays in receiving NextGenerationEU (NGEU) disbursements could raise financing concerns. Growth could be negatively affected by renewed jumps in energy prices, fragmentation of foreign trade and investment or a generalized decline in external demand.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the Italian economy's resilience to sequential adverse shocks, noting the strong recovery in output and employment. However, they noted that the fiscal deficit has widened sharply, the public debt ratio is very high, and core inflation remains elevated. A declining working-age population could lower economic growth over the longer term. With risks mainly to the downside, Directors highlighted the need to focus on fiscal adjustment and ambitious structural reforms to raise productivity and potential growth, and enhance energy security and meet the authorities' climate goals.

Directors underscored the importance of decisively lowering the public debt ratio and welcomed the authorities' commitment in this regard. They broadly supported frontloading fiscal adjustment by saving part of revenue windfalls and spending more efficiently, although a number of Directors considered the authorities' planned near-term adjustment to be adequate. Many Directors emphasized that Italy's overall risk of sovereign stress is moderate. Over the medium to long term, a strong primary surplus is needed to sustain steady, decisive debt reduction. Directors agreed that consolidation will need to be underpinned by well-defined and efficient measures, including a base-broadening tax reform, continued action on tax compliance, and pension reform. Growing primary current spending below the pace of nominal GDP would carve out room for public investment. Prudently managing publicly-guaranteed loans while strictly limiting new guarantees will also be critical.

Directors welcomed the improvement in banking sector buffers and the strengthened supervisory oversight in recent years but noted the still-sizable links between banks and the sovereign. Preserving financial stability in the context of tightening monetary policy and rising funding costs is a priority. Close attention will be necessary for banks with smaller liquidity cushions, sizable exposure to commercial real estate, and weaker business models. Maintaining adequate headroom on capital and liquidity on a forward-looking basis will also be important. Directors noted that banks' recourse to public-sector backstops should generally be avoided. Efforts to strengthen the AML/CFT regime should continue.

Directors underscored the need to raise potential growth and address future challenges. They recommended implementing comprehensive and ambitious reforms and resolving bottlenecks to critical investments while also promoting competition and transparency. Boosting productivity and labor force participation and closing the gender employment gap, including through improved education and better tax incentives, would help counter the effects of a contracting working-age population. Accelerating clean electricity capacity would strengthen energy security and support

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[2]At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

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climate targets. Directors encouraged the timely and effective implementation of the National Recovery and Resilience Plan supported by NextGenerationEU (NGEU) funding.

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

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Table 1. Italy: Summary of Economic Indicators, 2019-24

(Annual percentage change, unless noted otherwise)

	2019	2020	2021	2022	Projections 2023	Projections 2024
Real GDP	0.5	-9.0	7.0	3.7	1.1	0.9
Real domestic demand	-0.2	-8.4	7.2	4.3	0.9	1.0
Final domestic demand	0.2	-8.0	6.6	4.7	1.3	0.8
Private consumption	0.2	-10.4	4.7	4.6	1.3	1.2
Public consumption	-0.6	0.0	1.5	0.0	-1.1	-2.2
Gross fixed capital formation	1.2	-7.9	18.6	9.4	3.1	2.2
Stock building 1/	-0.5	-0.5	0.5	-0.4	-0.3	0.1
Net exports 1/	0.7	-0.8	0.0	-0.5	0.2	-0.1
Exports of goods and services	1.6	-13.5	14.0	9.4	2.2	2.8
Imports of goods and services	-0.7	-12.1	15.2	11.8	1.7	3.2
Savings 2/	21.6	21.6	23.7	20.5	22.2	23.9
Investment 2/	18.2	17.7	20.7	21.8	21.5	22.9
Resource utilization						
Potential GDP	0.4	-4.0	4.1	0.0	0.7	0.7
Output gap (percent of potential)	-1.8	-7.0	-4.3	-0.8	-0.4	-0.3
Employment	0.7	-3.1	0.8	2.4	0.8	0.1
Unemployment rate (percent)	9.9	9.3	9.5	8.1	8.0	8.1
Prices						
GDP deflator	0.9	1.6	0.6	3.0	6.2	3.6
Consumer prices	0.6	-0.1	1.9	8.7	5.2	2.5
Consumer prices (core)	0.6	0.5	0.8	4.0	4.8	3.2
Hourly compensation 3/	2.9	5.1	-1.8	3.2	4.5	2.5
Productivity 3/	0.5	0.8	1.4	-0.9	0.2	0.7
Unit labor costs 3/	2.4	4.4	-3.1	4.1	4.3	1.8
Fiscal indicators						
General government net lending/borrowing 2/	-1.5	-9.7	-9.0	-8.0	-4.5	-3.4
General government primary balance 2/ 4/	1.9	-6.2	-5.5	-3.6	-0.5	0.8
Structural overall balance (percent of potential GDP)	-0.6	-5.4	-4.6	-1.7	-2.1	-2.9
Structural primary balance (percent of potential GDP) 4/	2.7	-2.2	-1.2	2.7	1.9	1.2
General government gross debt 2/	134.1	154.9	149.9	144.4	140.5	138.8

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Exchange rate regime						
	0.9	0.9	0.8	0.9	...	...
Nominal effective rate: CPI based (2000=100)	103.0	105.2	106.4	104.6	...	...
Financial sector						
	-2.4	2.8	1.0	0.1	-2.0	-1.0
External sector 2/						
Current account balance	3.3	3.9	3.1	-1.2	0.7	0.9
Trade balance	3.4	3.6	2.3	-1.4	0.5	0.7
Capital account balance	-0.1	0.1	0.1	0.5	0.8	0.8

Sources: National Authorities; and IMF staff estimates.

1/ Contribution to growth.

2/ Percent of GDP.

3/ In industry (including construction).

4/ Primary revenue minus primary expenditure.

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ITALY

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

July 5, 2023

KEY ISSUES

Developments. Output grew robustly in 2022 despite surging energy prices on the post-pandemic recovery and fiscal stimulus. Inflation jumped and the current account fell into deficit. Employment reached new highs. Fiscal support and higher borrowing costs kept deficits large and public debt very high. Bank credit has begun to decline although loan quality continues to hold up. Italy's National Recovery and Resilience Plan (NRRP), supported by EU financial resources, aims to boost productivity and labor force participation, which would help offset the drag on growth from the declining working age population.

Outlook and risks. Scaling back crisis-era policy support will reduce GDP growth to 1.1 percent in 2023 and to 0.9 percent in 2024, with some pickup thereafter as NRRP-related spending accelerates. Underlying inflation is set to moderate gradually. Faster monetary policy tightening, prolonged delays in implementing the NRRP and receiving associated funding, or stalled progress on lowering public debt could weaken growth and trigger financing concerns. Escalating geopolitical tensions could create supply disruptions, including a renewed energy price spike. Stronger tourism is an upside risk.

Recommendations:

Fiscal policy. With overall risk of sovereign stress assessed as moderate, but on the borderline, together with still elevated inflation, more front-loaded fiscal adjustment is needed. Saving much of windfall revenue, better targeting of remaining energy measures, stricter controls on tax credits, and limiting ad hoc tax cuts would improve budget efficiency. To anchor medium-term debt reduction, a credible framework supported by well-defined measures—including a comprehensive revenue-enhancing tax reform and reducing costs of the legacy pension scheme—should be accompanied by growth-promoting structural policies. Maintaining a primary surplus of 3 percent of GDP while growing primary current spending—including tax expenditures—by at least 1-2 percentage points below nominal GDP growth would reduce debt and create room for public investment. Strong centralized management of public sector guarantees is needed.

Financial sector policies. Supervision and policies should be attuned to risks arising from tighter financial conditions, including adequacy of banks' funding plans, size of capital and liquidity buffers, quality of commercial real estate exposures, implications of

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heightened funding competition between banks and the government, and consequences for weaker banks of a future narrowing of net interest margins. Recourse to non-standard financial vehicles to mutualize banking sector costs should be limited.

Structural priorities. Prompt implementation of a comprehensive reform agenda is essential to lift productivity and potential growth. Accelerating public investment requires strengthened technical support to smaller municipalities and alleviating labor shortages, including by decreasing informality and turning to foreigners to fill domestic skill gaps. Measures to step up NRRP spending should not erode competition or the integrity of financial resources. Speeding up installation of renewable energy capacity would strengthen energy security.

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Approved By
Helge Berger (EUR) and Rishi Goyal (SPR)

The mission took place in Rome during May 8-23, 2023. The team comprised Rachel van Elkan (head), Sylwia Nowak, Karina Garcia, Magali Pinat, Sam Zhongxia Zhang, Apostolos Apostolou (all EUR), and Aleksandra Babii (MCM). Shafik Hebous (FAD), Fah Jirasavetakul (SPR), Jason Harris (FAD), and Natalia Stetsenko (LEG) attended some meetings virtually. Federico Giammusso, Cristina Quaglierini, and Francesco Spadafora (all OED) also participated. The mission met with Finance Minister Giorgetti, Bank of Italy Governor Visco, senior Italian and SSM officials, and representatives from the business community and trade unions. Ivana Rossi and Adrian Wardzynski (both LEG) contributed to the report, and Emily Fisher and David Velazquez-Romero (both EUR) assisted in preparing the report.

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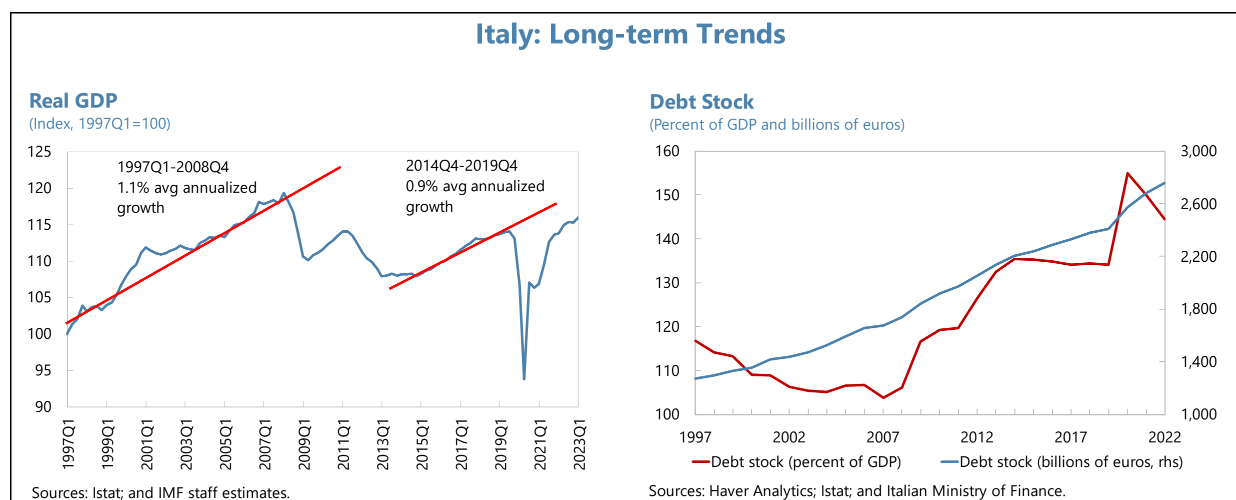
CONTEXT

1. Italy's economy has weathered the effects of Russia's war in Ukraine, but output has not returned to its modest pre-COVID path. Replacement of most Russian gas with alternative supplies but at considerably higher prices helped ensure adequate winter inventories and moderate energy demand. In recent years, output has been cushioned by highly-supportive fiscal, monetary, and financial responses to the COVID and energy price shocks, which generally strengthened private sector balance sheets but raised public debt to very high levels. However, while the Italian economy recovered more fully from the multiple crises of the past three years than did several other large euro area countries (Figure 1), the current level of GDP remains about 3 percent below its pre-crisis trend.



2. Growth is expected to enter a slower phase as support policies are unwound while the growth dividends from much-needed reforms and investments would take time to materialize. The withdrawal of fiscal stimulus and the tightening of monetary policy will dampen real activity in 2023-24. Given long lead times, ambitious structural policies are urgently needed to raise productivity and grow the active workforce to offset the drag on growth over the coming decades from Italy's rapidly aging population.

RECENT DEVELOPMENTS

3. The Italian economy grew robustly in 2022 despite higher energy prices. Output expanded by 3.7 percent in 2022 and 1.9 percent y/y in Q1: 2023 on strong domestic demand. Private consumption rose robustly on the recovery of employment, buoyant tourism, and extensive provision of fiscal compensation for loss of real purchasing power. Households also reduced saving from current income, leaving accumulated excess savings since the onset of the pandemic—partly from unspent government transfers—equal to about 8 percent of GDP at end 2022.[1] Generous tax credits fueled private investment, mainly in real estate ("Superbonus" scheme). Strong import growth, related to investment demand,

[1] The spending of these savings will tend to raise—albeit with a delay—the fiscal multiplier associated with those transfers.

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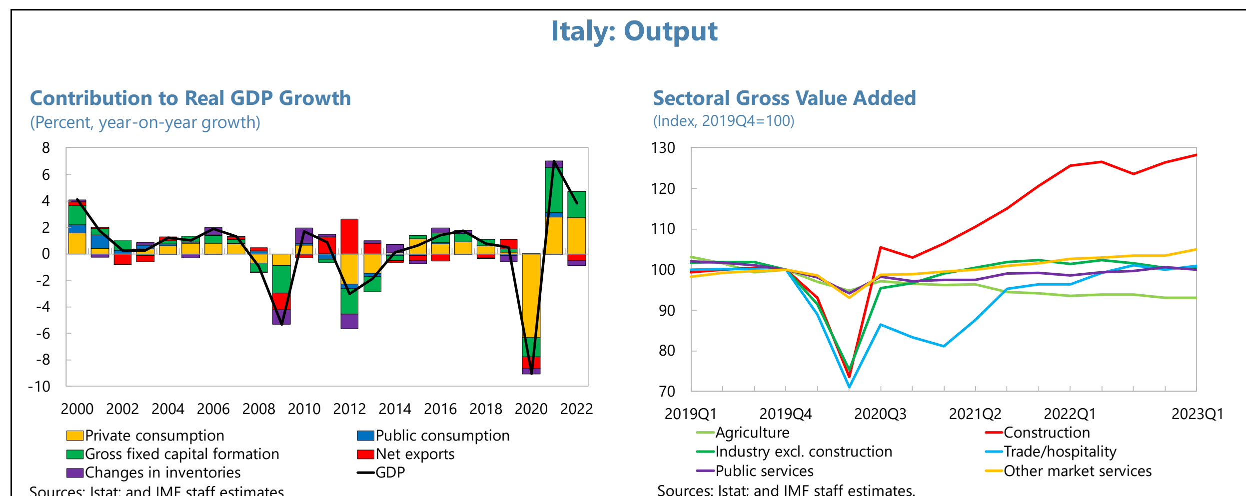
yielded a negative growth contribution from net exports in 2022 and Q1:2023. On the supply side, buoyant services and strong construction offset weakness in manufacturing, especially in energy-intensive industries that were affected by high energy prices. Leading indicators point to modest expansion in Q2:2023, with a widening divergence between services and industry.



4. After spiking in Q3:2022, energy prices reversed sharply, lowering headline inflation even as core inflation continued to increase until recently. Consumer prices increased by 8.7 percent in 2022, largely on surging energy prices, with headline inflation peaking at 12½ percent in fall 2022.[2] As energy prices moderated, headline inflation eased to 6.7 percent in June 2023 while the producer price index declined in May, with a deceleration across all categories. The share of the consumption basket running above the ECB's 2-percent target eased modestly to 80 percent in May (down from 90 percent in April) but elevated price pressures persisted, especially for non-regulated energy and food prices. Core inflation also increased strongly, by an average 4.0 percent in 2022 and 6.0 percent y/y in June 2023, underpinned by rising compensation of employees and profit margins. The GDP deflator growth begun to tick up from very low rates to 5.7 percent y/y in Q1:2023.

[2]The Bank of Italy found that international prices accounted for 90 percent of higher-than-expected increase in headline inflation in 2021-2022, with government measures dampening the rate of growth of consumer prices by about 1 percentage point (Bank of Italy, 2023, Annual Report for 2022). Nonetheless, in staff's view, inflation has been overstated by about 2 percentage points in 2022 because energy inflation is measured by tracking prices in new contracts only, rather than average prices that households pay.

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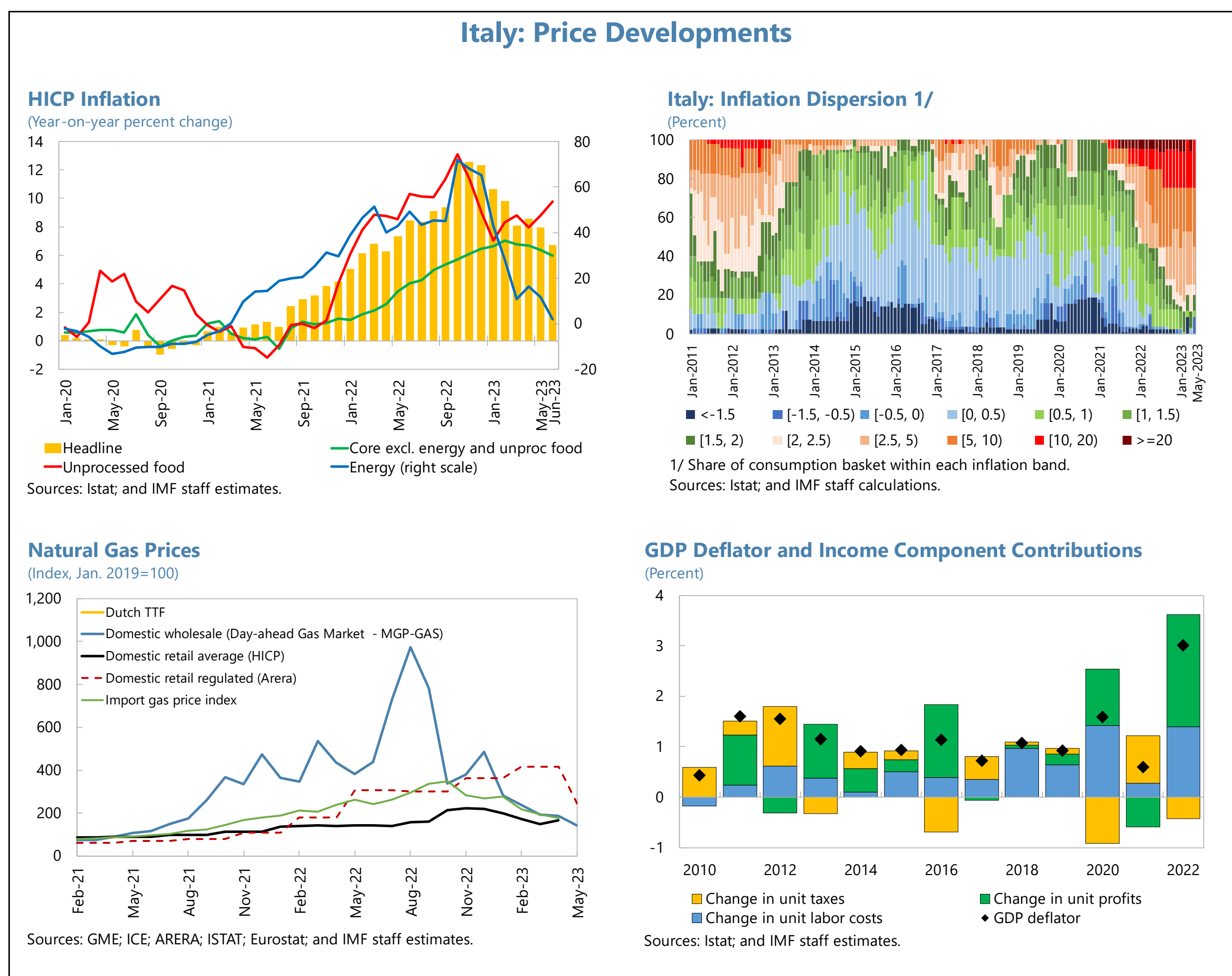

5. **The labor market has performed strongly since the pandemic and nominal wages have risen.** Employment expanded by almost 400 thousand since end-2019, with strong job growth in services and construction. Unemployment declined by almost 490 thousand through April 2023 (to 7.8 percent), with a substantial contribution from plummeting youth unemployment. Job vacancies climbed to historical highs, employment has shifted from temporary to permanent contracts in an effort to retain workers, and a growing number of firms report labor shortages at prevailing wages as holding back production. Shortages are amplified by rapid population aging. Nominal wages are rising in sync: all-in compensation per employee grew at 4½ percent in 2022 as firms topped up more sluggishly growing contractual wages with bonuses and one-off payments.[3] Firms' capacity to pay higher wages is supported by rising profits and widespread cuts in employers' social security contributions (covering youth, women, the South and Islands, and those transitioning from welfare). However, real wages fell by nearly 4 percent last year due to high inflation.

[3] Contractual wages grew by a modest 2.2 percent in Q1:2023 in year-on-year terms, largely reflecting the benchmarking of collective agreements to forecasts of headline inflation excluding imported energy.

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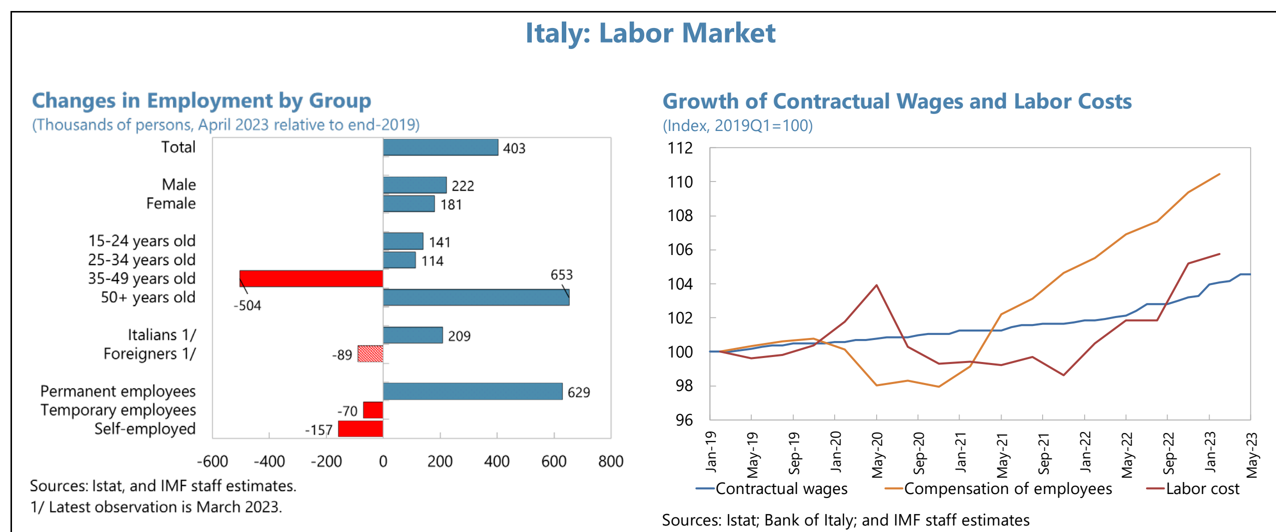

6. Italy's financial conditions have tightened considerably on the ongoing withdrawal of monetary stimulus. Sovereign yields have risen sharply since mid-2021, but recently stabilized around levels that prevailed prior to the GFC. Spreads over German bunds have moderated on more favorable perceptions of political risk and the availability in the ECB's toolkit of instruments to contain asymmetric transmission of monetary policy within the monetary union.[4] Foreign holdings of Italian government securities have declined over the past year, while those of residents—mainly large retail customers—have risen. Bank lending conditions have tightened sharply since Q2:2022 on rising risk perceptions, reduced risk tolerance, and higher bank funding costs. The BIS estimated credit gap, which has been negative and widening for most of the past decade on account of the economic restructuring and banks' rebuilding of capital buffers following the earlier crises, has begun to rewiden. Tensions in US and Swiss banking systems in March 2023 caused only limited, temporary spillovers to Italian banks' equity prices and CDS spreads. Tightening monetary policy reduced the Bank of Italy's (BdI's) profits in 2022 as net interest income declined, which would reduce profit transfers to the government (Annex VI).

[4] According to the ECB, flexible reinvestment of maturing securities acquired under the Pandemic Emergency Purchase Program is the first line of defense to tackle disruptions to market functioning, while the Transmission Protection Instrument (TPI) was introduced in June 2022 to reduce financial fragmentation risks. While introduction of the TPI had a calming effect on markets, it has not been activated.

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Italy: Financial Conditions

Goldman Sachs Financial Conditions Index
(Index)

Sources: Goldman Sachs; and Bloomberg, LP.

Tightening of Bank Lending Standards
(Net percentages of banks reporting a tightening of lending standards and contributing factors)

Banks' risk tolerance; Risk perceptions; Competition; Cost of funds and balance sheet constraints; Credit standards (actual)

Sources: ECB Bank Lending Survey; IMF staff estimates.
Notes: The net percentages are defined as the difference between the percentage of banks reporting a tightening due to a given factor and the percentage of banks reporting an easing.

Credit Gap
(Percent of GDP)

Credit-to-GDP gap (RHS); Credit-to-GDP ratio; Credit-to-GDP trend

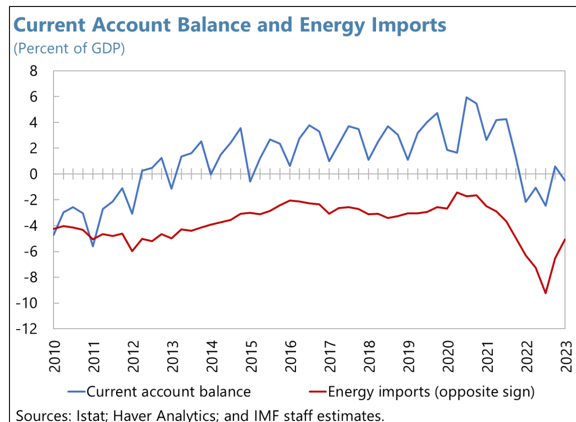
Source: BIS.

Change in General Government Debt Holding
(Billions of euros; cumulative change since Dec2021)

Bank of Italy; Monetary Financial Institutions; Financial Institutions; Other Residents; Non Residents

Sources: Haver Analytics; Bank of Italy; and IMF staff estimates.

7. **The current account surplus swung to a 1¼ percent of GDP deficit in 2022 on higher prices of imported energy.** The 4¼ percent of GDP decline in the current account was mainly due to a 3¼ percentage point increase in the energy deficit on the much higher price of imported gas, which was concentrated around July-September 2022. The current account decline reflected a drop in household saving net of investment by 4 percent of GDP, while the increase in investment was driven mainly by tax credits. The effect of the energy price spike on the real effective exchange rate was cushioned by depreciation of the euro. Staff assesses that the external position in 2022 was weaker than the level implied by medium-term fundamentals and desirable policies; however this assessment is subject to unusually high uncertainty regarding the extent to which the energy price shock was perceived as persistent at the time of its occurrence, compounded by the fact that Italy experienced the largest negative energy terms of trade shock among the countries included in the external



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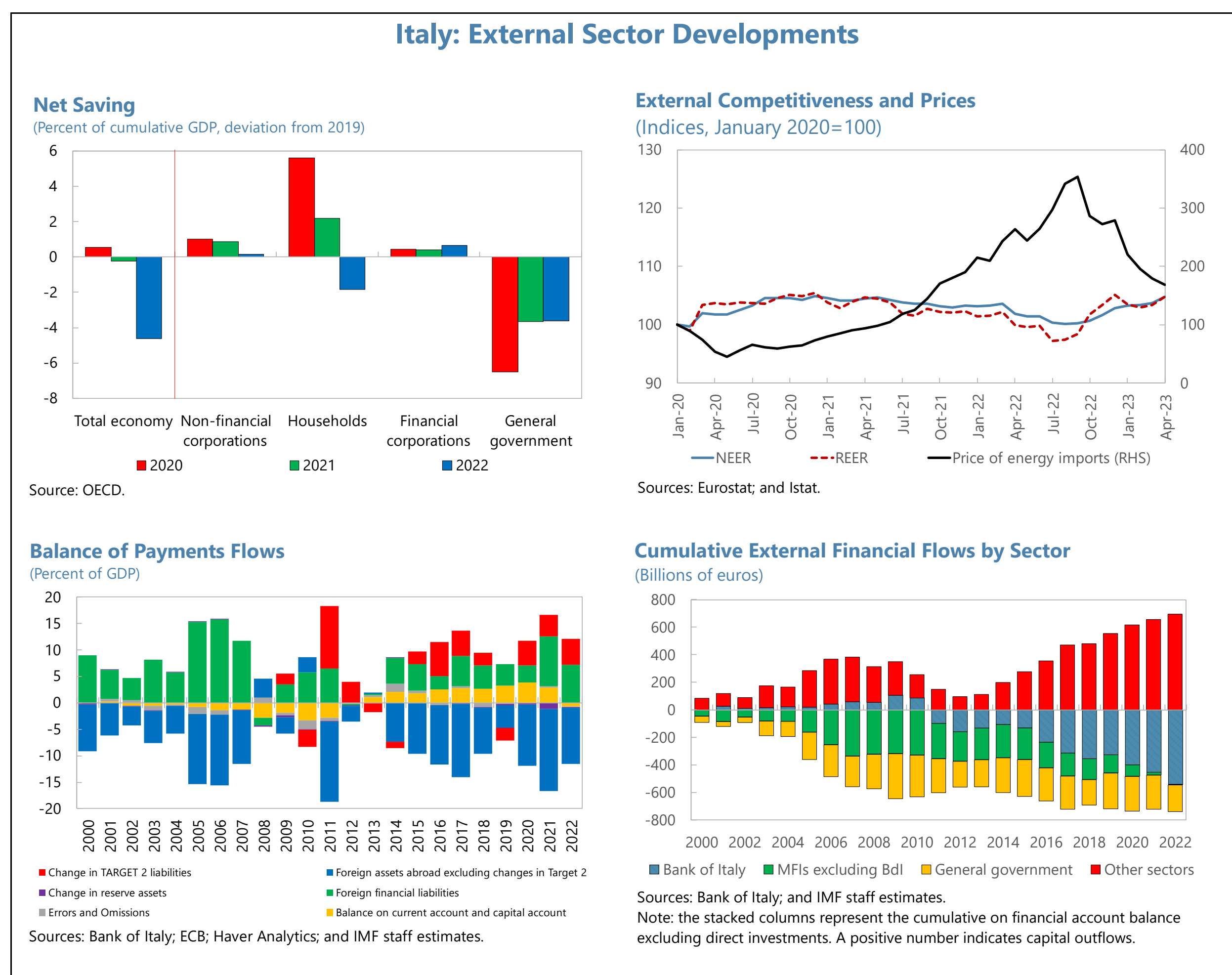
balance assessment (Annex III).[5] Moreover, while a negative shock could trigger an increase in precautionary saving (thereby raising the current account balance), Italy's adverse commodity price shock resulted in saving in the form of gas in storage, which was accumulated at very high import prices, thereby deteriorating the current account.[6] Falling energy prices caused the current account to return to surplus in Q4:2022 without the need for a macroeconomic policy intervention. Residents continued to increase their holdings of foreign assets, which was largely balanced by an increase Target 2 liabilities and portfolio inflows by nonresidents.



[5] With the terms of trade shock mainly concentrated in a few months, this would tend to reduce the perceived persistence of the shock. Europe's gas import price surge dissipated much more quickly than the energy price surges of the 1970s and 1980s as the global liquid natural gas market is integrated and includes many suppliers. As a result, part of the price shock was borne by gas importers outside of Europe (Market Size and Supply Disruptions: Sharing the Pain of a Potential Russian Gas Shut-off to the European Union (imf.org)

[6] In addition, the level of gas in storage at the onset of the terms of trade shock around April 2022 was much lower than the usual seasonal pattern, implying that reaching storage capacity by late autumn required a larger volume of imports.

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REPORT ON THE DISCUSSIONS

Against the backdrop of extensive fiscal, monetary, and financial support in recent years, the discussions focused on managing the transition to a more restrictive regime: (i) the macroeconomic outlook and associated risks; (ii) managing the fiscal policy challenges brought by multiple crises; (iii) ensuring financial sector resilience in the new environment; and (iv) addressing structural reforms and investment needs to meet demographic, energy, climate, and geo-economic fragmentation challenges.

A. Outlook and Risks

8. Revival from the health and energy emergencies and withdrawal of exceptional policy stimulus will shift growth to a lower gear, even with support from the National Recovery and Resilience Plan (NRRP). Household consumption is forecast to grow modestly on higher employment, accelerating wage growth, and a temporary decline in the saving rate while fiscal support to disposable incomes has been reduced alongside the fall in energy prices. Tightening monetary policy and the gradual phasing out of the building tax credit schemes are projected to moderate private investment, while NRRP-financed public investment is scheduled to peak at 3.5 percent of GDP during 2024-26 before easing to 3 percent of GDP in 2028—an increase from the pre-COVID average of 2.3 percent of GDP. In all, growth is forecast to moderate to 1.0 percent on average in 2023-24 and to remain around 1.1 percent from 2025 as NRRP spending peaks. Despite population aging, potential growth in the next few years is expected to edge up marginally to 0.8 percent on ongoing implementation of structural reforms and improvements in public infrastructure.

9. Headline and core inflation will remain above 2 percent through 2025. Headline inflation is expected to decline steeply to 5.2 percent in 2023 and 2.5 percent in 2024, driven by lower energy and food prices. However, rising wages and growing profit margins will keep core inflation and the GDP deflator above 2 percent until 2025. Nominal growth in contractual wages is due to accelerate over the course of the second half of 2023 and persist in 2024, reflecting: (i) strong increases in the official forecasts of the inflation index used for collective bargaining agreements (6.6 percent in 2023 and 2.9 percent in 2024); and (ii) the need to renew expired multi-year contracts of over half of all workers.

10. While positive surprises are possible in the near term, downside risks dominate the growth outlook (Annex I). A sharper tightening of monetary policy brought by more persistent euro-area inflation could transmit asymmetrically to Italy and further raise borrowing costs. Renewed global financial stress could reduce funding availability, causing public and private spending to retrench and reviving concerns about sovereign-bank-corporate linkages, including through calls on publicly-guaranteed loans to the private sector. Policies that slow public debt reduction or prolonged delays in receiving NextGenerationEU (NGEU) disbursements could raise financing concerns. Given these vulnerabilities, a severe global financial stress scenario (as in Box 1.3 of the April 2023 WEO) could hit Italy's GDP harder than in many other advanced economies. Under such a severe downside scenario, Italy's GDP could decline by about 2 percentage points below the baseline in 2023 and 2024. The further increase in sovereign borrowing costs from already elevated levels would heighten concerns over fiscal funding conditions and debt sustainability, potentially forcing a sharp pro-cyclical fiscal adjustment.

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Financing constraints for banks would intensify. Separately, escalating geopolitical tensions or extreme weather events could disrupt supply and demand.[7] Stalled progress on implementing the NRRP would lower support to output and weaken future productivity prospects. On the upside, growth could prove more resilient, especially in the tourism industry that could benefit from pent-up demand by foreign tourists.

Authorities' Views

11. The authorities are somewhat more optimistic than staff on growth prospects and saw risks as two-sided. The economy has shown greater resilience in recent years than many forecasters had predicted. External competitiveness has improved on sustained wage moderation, exports have grown strongly, and—adjusted for the energy terms of trade shock—external balances are in line with fundamentals. Financial positions of households and companies are sound. Employment has surpassed pre-pandemic levels, mainly on new permanent contracts, and labor market participation has risen. Increased spending under the NRRP is expected to support growth, which is forecast to reach 1.2-1.4 percent this year, and up to 1.5 percent in 2024. The upswing in headline and core inflation last year was largely driven by rising energy costs and the subsequent decline in energy prices is expected to reverse this inflation process, but with a more gradual path for core inflation. Wages and prices are not expected to propagate inflationary spirals, in part because temporary tax and social security cuts have lifted disposable incomes, thereby mitigating wage-catchup demands. Reforms and public investments in the NRRP are expected to boost productivity, and together with increased labor participation of women and youth, would counter the effect on output from a declining population. Increased financial support to families is intended to raise the birth rate. Positive growth surprises remain possible, as demonstrated by the recent upward revision for this year and next. However, growth would be negatively affected by renewed jumps in energy prices, the fragmentation of foreign trade or a generalized decline in external demand, and a further sizable increase in interest rates and an excessive retrenchment of credit.

[7] See the forthcoming the IMF European Department paper "Geo-economic fragmentation: what's at stake for the EU?" by Baba, Lan, Mineshima, Misch, Pinat, Shahmoradi, and van Elkan.

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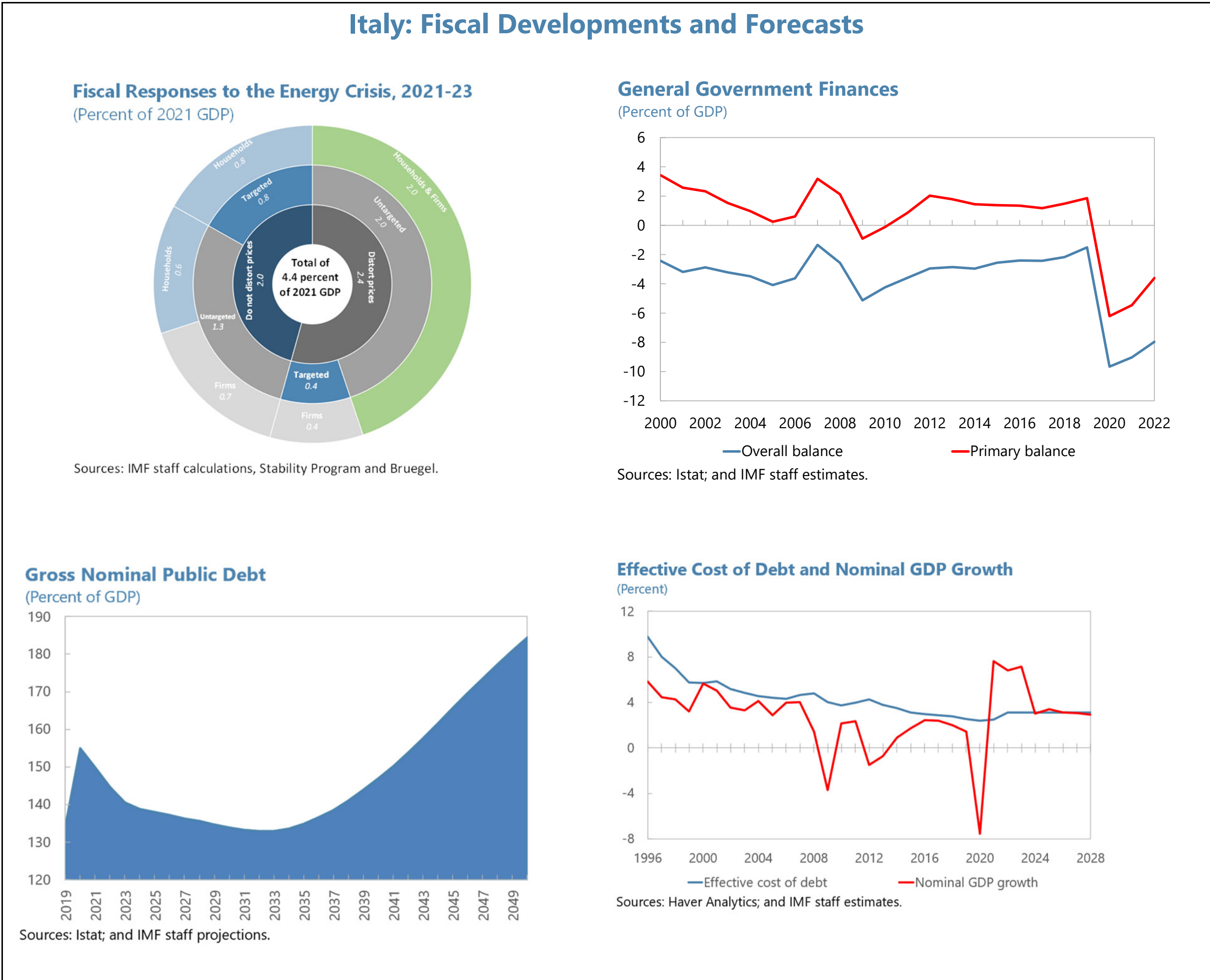
B. Fiscal Policy to Navigate Shocks and Preserve Sustainability

Background

12. Extensive policy support and rising interest costs have kept fiscal deficits very high in recent years. The headline deficit averaged 8.9 percent of GDP during 2020-22 on measures to cushion the COVID and energy price shocks, tax incentives to support recovery of construction and employment, and a rising interest bill on the higher cost of borrowing and larger payments on inflation-linked debt. While much of the fiscal support for the energy price shock was initially untargeted—but similar to the EU average—the extent of targeting has increased over time to about 2/3 of measures. The Superbonus scheme, with its 110 percent of rate of tax credit (since lowered to 90 percent and to be reduced to 65 percent next year), is inefficient because it subsidizes some investments that would have occurred in the absence of benefits, is regressive as property ownership is required and eligibility is not means tested, and has achieved only modest abatement of carbon emissions. The public debt ratio declined to 144 percent of GDP in 2022, some 10 percentage points below its peak in 2020, on the sharp recovery in nominal GDP.



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13. The government is targeting a large reduction in the headline deficit in 2023 with smaller declines thereafter; however, additional cash borrowing needs will add to debt. The authorities are targeting a 3½ percentage point reduction in the headline deficit to 4.5 percent of GDP for 2023, to be achieved by scaling back Superbonus capital transfers and lowering spending on energy price compensation. They envisage further adjustment in subsequent years to reach a headline deficit of 2.5 percent of GDP in 2026, with a primary surplus of 2 percent of GDP. Claims for tax credits under the Superbonus and other incentive schemes are expected to add about ¾ percentage point on average to borrowing needs for the next five years. As a result, and together with the higher cost of borrowing, the government forecasts that the debt ratio will decline only modestly during 2024-26. New guidelines have been issued for a reform of the tax system with the goal of lowering the tax burden, reducing avoidance and evasion, and aligning the system with EU and recent OECD recommendations (Box 1).

Staff's Views

14. Italy's overall risk of sovereign stress is assessed as moderate, but on the borderline (Annex II). Volatility reflecting high-frequency global and country specific developments constitutes a near-term risk, although this is mitigated by the relatively-long average maturity of government debt. Risk at the medium-term horizon is judged as moderate given sizable gross financing needs and increased reliance on private sector funding as the ECB continues to reduce its sovereign bond holdings. Scope to further increase holdings by the retail sector—typically buy-and-hold investors—would lengthen the effective maturity of debt. However, high uncertainty over assumptions (e.g., the interest rate-growth differential), and with the mechanical signal for the medium-term horizon close to the upper threshold, the assessment for the medium term is sensitive to small policy deviations, and which could also raise the overall risk assessment. Rising pension obligations under the legacy defined-benefit scheme and a shrinking working age population are expected to place the public debt ratio on a rapidly rising path within a decade. The risk of sovereign stress at the long horizon is therefore viewed as high.

15. Given the moderate risk of sovereign stress and the need to support disinflation and build fiscal buffers, a faster improvement in the primary balance is warranted and feasible. The primary balance target for 2023 remains below pre-pandemic levels, largely on account of conservative revenue forecasts and the still-high capital spending related to tax credits. The revised statistical treatment of previous tax credits and the estimated gains from higher price deflators suggest revenue outturns through the medium term could be considerably stronger than projected—on the order of 2 percent of GDP. Saving much of this revenue windfall to reach a primary surplus of around 1 percent of GDP this year is advised.[8,9] A lower deficit would also help to moderate prices and help smooth across time the

[8] Not spending the tax revenue gains from the change in Superbonus accounting would have no macroeconomic impact but if spent on poorly-targeted transfers and tax relief, the macroeconomic effect would be minimal. Any contractionary effect from saving the revenue windfall from higher price deflators would likely be mitigated by faster drawdown of the large stock of household savings, including those accumulated from COVID-era fiscal support programs.

[9] Central government cash-based performance during January-May 2023—which can deviate significantly in either direction for an extended period from the general government accrual-based measure—was much weaker than during the corresponding period of 2022. This reflects delays in receiving NGEU grants, increased claims of tax credits related to the Superbonus (which have a cash impact but not an accrual one), and tax expenditures.

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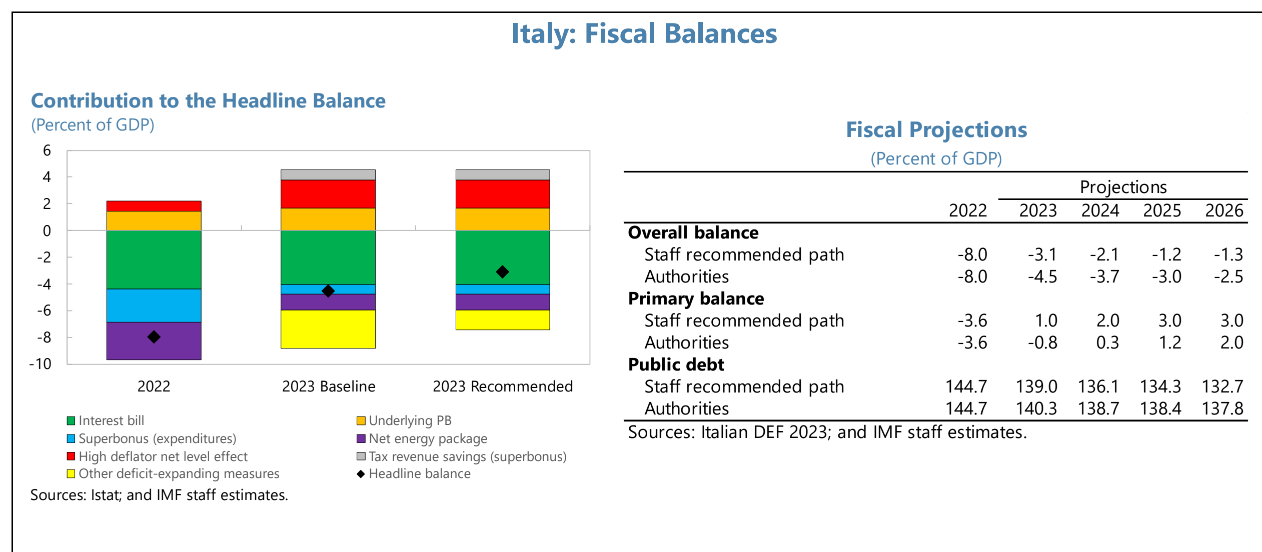
significant fiscal effort needed to prevent future widening of the deficit due to rising pension spending and the declining working age population.



Fiscal Projections
(Percent of GDP)

	2022	Projections 2023	2024	2025	2026
Overall balance					
Staff recommended path	-8.0	-3.1	-2.1	-1.2	-1.3
Authorities	-8.0	-4.5	-3.7	-3.0	-2.5
Primary balance					
Staff recommended path	-3.6	1.0	2.0	3.0	3.0
Authorities	-3.6	-0.8	0.3	1.2	2.0
Public debt					
Staff recommended path	144.7	139.0	136.1	134.3	132.7
Authorities	144.7	140.3	138.7	138.4	137.8

Sources: Italian DEF 2023; and IMF staff estimates.

16. There is scope to further increase spending efficiency, including in the near term. The government has implemented or approved several welcome measures this year to improve the targeting of benefits, including reducing the degree of indexation for higher pensions and reinstating some taxes and charges on energy. Further efficiency gains are feasible:

- *Energy measures*. There is room to further refine targeting of energy compensation to households and firms by fully reinstating VAT and system charges on gas. In addition, any compensation should be limited only to the temporary component of higher energy prices.

- *Balanced-budget financed spending*. Targeted income-redistribution, financed from revenue windfalls, was appropriately used in 2022 to respond to the temporary energy price shock. However, using revenue windfalls to finance tax relief is not well suited for permanently raising structurally-low incomes, which instead requires improving labor productivity and boosting potential growth.

- *Tax credits*. Reinforcing financial controls on approvals of Superbonus and other tax credits, ensuring strict compliance with program objectives, targeting eligibility to lower income households and sharply reducing the subsidy rate would limit budgetary overruns and wasteful spending.[10]

17. Beyond the near term, a credible fiscal framework with well-defined measures, accompanied by growth enhancing reforms, is needed to anchor debt reduction. Saving windfall revenue should over time be replaced with more efficient fiscal measures that promote sustainable and inclusive growth and boost productivity to deliver durable debt reduction. This requires structural reforms (section D) and increased public investment in physical and social infrastructure, which was sacrificed during the last 10-15 years to make room for higher social spending and the proliferation of

[10] See Annex VII in the Italy 2022 Article IV staff report.

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tax expenditures. To consistently lower the debt ratio and accommodate increased public investment, pursuing a spending path—including tax expenditures—whereby primary current spending grows by at least 1 to 2 percentage points below nominal GDP growth while maintaining a 3 percent of GDP primary surplus from 2025 onwards is recommended. This would reduce the debt ratio to around 130 percent of GDP by 2028. If combined with closing labor force participation gaps with the EU, stepping up immigration, or higher growth, debt could decline to around 90 percent of GDP within 20 years. Progress could be reinforced by a reduction in the risk premium demanded by investors as the debt ratio declines.[11] While a broad-based review of the budget would aid in identifying savings, considerable savings are feasible in the areas of taxation and old-age pensions:

- *Tax system*. A comprehensive tax reform is needed to broaden the tax base and increase efficiency and equity (Box 1). Further reducing large compliance gaps and narrowing policy gaps—including by rationalizing tax expenditures (costing around 6 percent of GDP in foregone annual revenue)[12]—would reduce complexity and bolster revenue. Updating property values in the cadastre (last done in the 1980s) would support more equitable tax treatment. It is essential that the chosen reform of the tax system promotes employment, abolishes ineffective tax expenditures, reinforces revenue collection, and protects progressivity. A flat tax on personal income could have adverse implications for equity and lead to significant revenue loss. Continuing to strengthen tax compliance is also needed, and lifting the ceiling on permitted cash transactions and introducing an amnesty on tax debt are not helpful.

- *Pension spending*. Pensions cost the budget 16 percent of GDP against a euro-area average of around 13 percent. Pension spending is expected to increase over the next 25 years as the population ages, adding up to 2¼ percentage points to spending and substantially adding to public debt over the medium-to-long run, despite the introduction of a notional defined-contribution scheme that will gradually accrue savings and strengthen very long-term pension sustainability.[13,14] There is scope to trim costs of the legacy scheme by reducing the wage replacement rate (67 percent) closer to the euro area average of around 50 percent and raising the effective retirement age (currently under 64) closer to the statutory age (67 years) by avoiding any new early retirement arrangements. These measures could yield up to ¾ percent of GDP in annual fiscal savings.

[11] An accompanying Selected Issues paper, "Determinants of Sovereign Bond Spreads in the Euro Area", finds that yield spreads relative to German bunds tend to widen (narrow) as monetary conditions tighten (loosen), and that this widening (compression) is more pronounced for countries with higher public debt ratios.

[12] Italian Ministry of Finance and Economy, 2022, "Rapporto annuale sulle Spese Fiscali 2022,"Commissione per le Spese Fiscali.

[13] These projections reflect the dampening effect of past pension reforms—raising the retirement age under the defined benefit scheme to 67 and introducing in 2011, on a pro-rated basis, a notional defined contribution scheme.

[14] Staff's projected increase is about ½ percentage point higher than those in the 2021 EC aging report. In addition to demographic forecasts, projections are sensitive to numerous macroeconomic assumptions, including potential growth and the employment rate.

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18. To limit materialization of contingent liabilities, the large stock of public sector guarantees requires strong centralized oversight and prudent management. Credit guarantees with high coverage rates can provide vital and rapid support to economic activity in times of crisis. However, they should not be the instrument of choice for promoting strategic policy goals as they may delay recognition of fiscal costs and encourage adverse selection of riskier borrowers and banks. The current low default rate on guarantees may not be informative for future performance given ongoing policy support to firms, that grace periods on principal repayments expired only recently, and in view of the long maturity of guaranteed loans (Box 2). Prudent, centralized monitoring and management of existing guarantees is essential to reduce the risk that guarantees will be called and add to government debt. Monitoring data should be regularly reported. Banks should pursue borrowers with impaired guaranteed loans using similar tools and strategies as they would non-guaranteed loans and with timely mandatory reporting on guarantee quality to the public-sector managing entities and the Ministry of Finance. Stress testing the guarantee portfolio under adverse scenarios should guide provisioning decisions. New guarantees should be strictly limited and coverage rates should be lowered, with enhanced credit risk assessments by banks at origination. Gradually reducing the stock of guarantees to pre-pandemic levels is advised.

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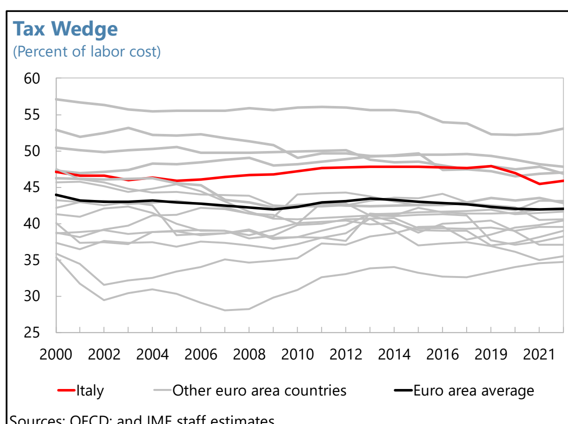
Box 1. Italy's Tax System and Reform Needs

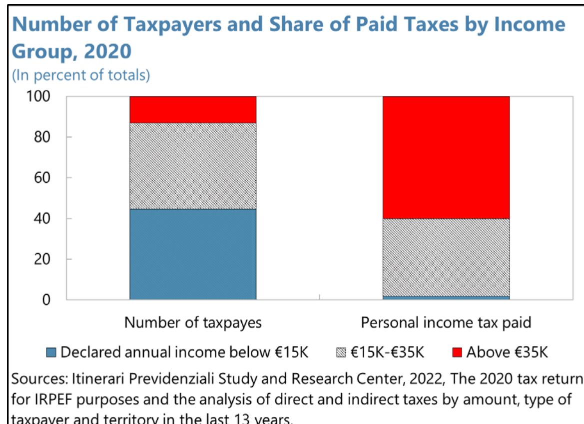
The Italian tax system is characterized by its reliance on high rates to generate revenues, with a narrow tax base resulting from policy and compliance gaps. Italy's revenue, including social security contributions, is one of the highest relative to GDP reaching 45 percent (behind Denmark, France and Austria in 2021). The revenue forgone from a plethora of tax expenditures (more than 625 individual items) is estimated at €125 billion (6.3 percent of GDP)[1]. The frequent modifications and the temporary nature of many tax expenditures create uncertainty for taxpayers. The tax wedge on labor is a very high 45 percent of labor cost, thereby discouraging labor supply. Other marginal statutory rates are slightly higher than the EU average, with the corporate income tax rate at 24 percent (the EU average is 21.3 percent), and the standard VAT rate is 22 percent. Moreover, significant compliance gaps hinder the proper function of the Italian VAT as a broad-base consumption tax. The recurrent property tax is underutilized, with outdated cadastral values from the late 1980s and exemptions for the primary residence.

Tax treatment of personal income varies by source. The PIT system for wage earners is subject to a progressive rate structure with four rates (reduced from five in 2022) ranging from 23 percent to 43 percent for income over €50,000. However, the self-employed are taxed at a favorable flat rate of 15 percent on incomes up to a relatively high ceiling (€85,000 in 2023, up from €65,000 in 2022). The distribution of income from self-employment reveals a sharp reduction in the number of self-employed declaring incomes in excess of the (former) €65,000 ceiling, indicative of large underreporting of higher incomes and which motivated the raising of the ceiling.



Sources: OECD; and IMF staff estimates.

Tax non-compliance is pervasive. The VAT compliance gap in 2020 is estimated at about 20.8 percent of the total VAT liability, compared to about 9.1 percent for the EU average (EU CASE, 2022). The compliance gap for personal income tax on the self-employed is estimated at 67 percent of the total tax liability. Total revenue lost to tax evasion was estimated at €109 billion (close to 6 percent of GDP).[2] According to Itinerari Previdenziali (2022), nearly 60 percent of Italians report annual incomes below €10,000. As a result, personal income tax is relatively concentrated, with 60 percent of receipts paid by 13 percent of taxpayers with declared incomes of over €35,000.



Sources: Itinerari Previdenziali Study and Research Center, 2022, The 2020 tax returns for IRPEF purposes and the analysis of direct and indirect taxes by amount, type of taxpayer and territory in the last 13 years.

Measures have been introduced in recent years to strengthen tax administration and reduce evasion. Compulsory electronic invoicing, government incentives to encourage the electronic payments and the pandemic have contributed to reducing the VAT compliance gap. Additional measures against tax evasion are part of the NRRP reforms, including improved targeting of audits and controls, and further digitalizing tax administration. However, the 2023 budget raised the legal limit for cash transactions and re-introduced an amnesty on outstanding tax bills, which could weaken tax discipline.

The government recently proposed a major reform of the tax system. The Draft Framework aims, inter alia, to reduce the tax burden on firms and households to stimulate economic growth, reduce tax avoidance and evasion through greater use of technology, and improve

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Box 1. Italy's Tax System and Reform Needs (Concluded)

international tax competitiveness. It is envisaged that the reform would be implemented within 2 years. The reform aims to rationalize the current system of tax expenditures by reducing their number and embedding them within the corporate and personal systems. In staff's view, while the objectives stated in the Framework are sound, it is not clear whether the proposed reforms are the most efficient and effective way to achieve them. In particular, the intention to gradually transition to a flat PIT rate (by sequentially reducing the number of tax brackets each year) would be costly in terms of revenue and puts progressivity at risk. Using tax credits to lower the tax burden at the bottom of the income distribution (as it is currently the case) is a good practice that should continue. In contrast, the existing family ("dependent spouse") tax credit, for example, disincentivizes labor supply by non-working spouses particularly at the lower levels of income, and thus should ideally be replaced by an in-work tax credit. Applying two separate rates on corporate profits, with a lower rate applied to retained profits used for hiring or investment, would be extremely difficult to administer and an ill-targeted design. Instead, Italy should build on its existing strong features that directly target investment—such as tax credits and the allowance for corporate equity—for a growth-friendly CIT design.

A tax reform in Italy should rely on effective and efficient measures to encourage investment and employment while respecting revenue and progressivity objectives. Lowering the tax burden on labor income by reducing marginal rates, while preserving progressivity and streamlining tax credits and deductions, would benefit low and middle-income households and boost formal sector employment. Shifting from labor taxes towards greater reliance on consumption and property taxation would lower the labor tax wedge, markedly support higher labor participation and boost growth. Updating property values and reintroducing the recurrent property tax on primary residences (as in many OECD countries) would raise revenue efficiently. A simple and stable business taxation strategy that includes an allowance for corporate equity and removes inefficient incentives would support investment and lift Italy's low growth potential (IMF working paper 18/59).

1/ Senate Hearing of the Director General of Finance, Ministry of Economy and Finance, G. Spalletta, 2023, "Hearing on Tax Incentive Instrument with Particular Reference to Tax Credits," Rome, February 2023.
2/ Ministry of Economy and Finance, 2019, "Relazione sull'economia non osservata e sull'evasione fiscale e contributive," Nota di aggiornamento del Documento di Economia e Finanza 2019.

Authorities' Views

19. The authorities are committed to preserving fiscal sustainability and will continue to lower the public debt ratio also within the framework of the forthcoming new EU fiscal rules. The current prudent approach to public finances will be maintained, and the government has shown its ability to take difficult decisions in support of prudence. The successful launch of several new retail savings bonds demonstrates the resilience of the Treasury's debt management strategy to the tighter monetary conditions. Inefficient spending is being eliminated, including the Superbonus scheme where the cost has eventually exceeded the benefit. Temporary tax and social security cuts serve to mitigate the cost of living shock for low- and middle-income families, while also containing wage demands and supporting growth. Italy has a strong track record of running primary surpluses and aims to return to a 2 percent primary surplus by 2026. Removing remaining energy compensation measures and conservative growth in nominal spending will deliver the envisaged targets, and a package of growth enhancing reforms and investments will be prepared by early-2024 to guide future adjustment, aided by a review of spending. The planned tax reform, which will be fully financed, will gradually lower the tax burden on households, workers and firms, simplify the tax system and strengthen the economy's supply side by encouraging investment, innovation and employment. The resulting faster output and productivity growth will help to reduce the debt ratio and raise wages and competitiveness. Real interest rates are expected to remain below real growth rates, at least in the short-to medium term. Public guarantees related to the pandemic

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emergency will continue to decline gradually in line with scheduled loan amortization, returning to their pre-COVID level in the medium term. New guarantees will support investment needs, including those related to the green transition, in accordance with terms and conditions of the EU Temporary Crisis and Transition Framework or at market-based terms. Long-run pension system sustainability is assured by the notional defined-contribution system that is already in place, and together with declining interest spreads, will deliver a downward path for the debt ratio from 2050.

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Box 2. Italy's Public Guarantees

Public guarantees related to private-sector debt obligations amount to 16 percent of GDP and originate mainly from COVID and energy-related loan schemes. Guarantees vary by firm size, and include more than 1 million loans of less than €30,000 with 100 percent guarantee cover to small and micro firms, classified as "standard", and for which provisions equal to the expected loss are recorded as fiscal spending when the guarantee is issued. Guarantees to large firms are "one-off," and the budgetary impact is recorded only if and when the guarantee is called.

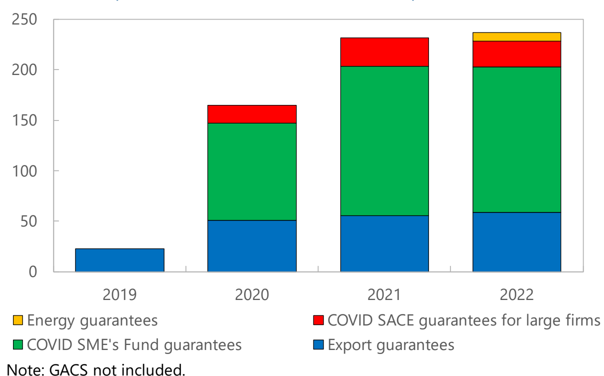
Italy: Public Sector Guarantees for the Economy, End-2021 1/

	Outstanding guarantee amount (Percent of GDP)
Total	16
of which: one-off guarantees	6
of which: standard guarantees	10
Memorandum item:	
Guarantees provided to non-financial corporations (NFCs)	35% of total bank loans to NFCs

Sources: Eurostat; European Commission; Ministry of Finance; and Bank of Italy.
1/ Includes guarantees by public financial and non-financial corporations (MedioCredito Centrale, etc.) that are outside the general government.

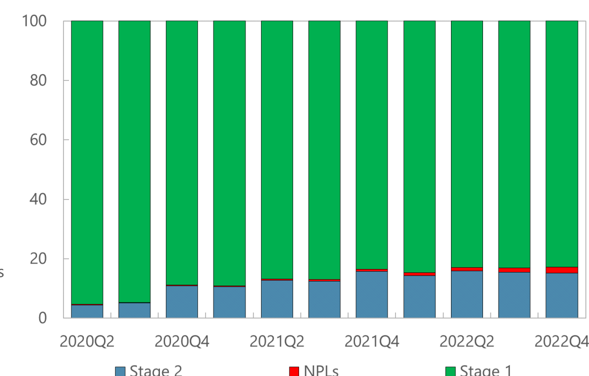
Calls on guarantees have been low so far. The NPL rate of guaranteed loans was 2 percent at end-2022, although the share classified as Stage 2 has risen. The maturity profile of guaranteed loans varies across schemes, with a ceiling of 15 years for micro loans under the COVID temporary framework and a maximum of 8 years for energy guarantees. The majority of COVID-related small loans is due in 2026-27. Under existing regulation, new guarantees are available with coverage rates of 60 and 80 percent for working capital and investment purposes, respectively.

Main Guarantee Schemes
(Guarantee exposure amount, billions of euros, end period)

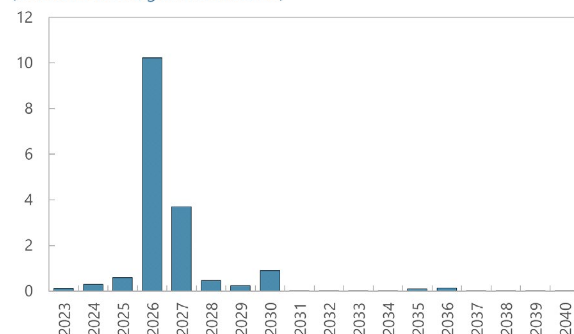


Note: GACS not included.

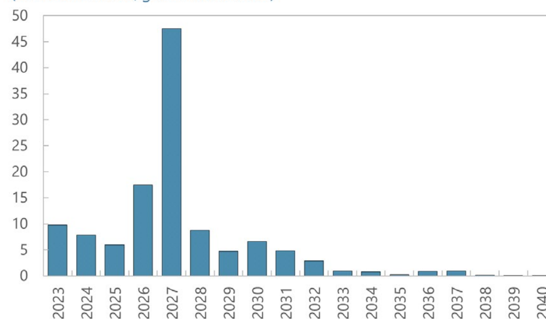
Bank Loans under Public Guarantee by IFRS9 Stage
(Percent)



Maturity Distribution of COVID-related Micro Loans (less than €30,000) by the SME Guarantee Fund
(Billions of euros, guaranteed stock)



Maturity Distribution of Other COVID-related Loans by the SME Guarantee Fund
(Billions of euros, guaranteed stock)



Sources: European Banking Authority; Ministry of Finance; SACE Guarantee Fund; and Italy's Central SME Guarantee Fund.

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C. Ensuring Financial Sector Resilience

Background

20. Notwithstanding considerable strengthening of the financial sector over the past decade, supported by improvements in supervision and regulation, pockets of vulnerability remain. Consolidation, mainly from merging some 200 entities into two significant cooperative groups, sharply reduced the number of banks to around 120. Bank solvency has risen significantly on higher capital and de-risking of assets. NPLs—gross and net of provisions—declined sharply over the past decade to close to the EU average, including through securitizations supported by government guarantees (GACS). Prices of residential and commercial real estate (CRE) have declined for much of the past decade. CRE accounts for 7 percent of banks' total loans but 22 percent of NPLs. More complete pass through of higher policy rates to lending rates than to deposits rates, especially overnight deposits, has boosted banks' profits over the past year. Stocks of loans and deposits have declined on the higher cost of borrowing, shifts to higher-yielding instruments, and repayment of firms' loans for liquidity buffers. Remaining TLTROs exceed excess reserves for half of banks—but not the largest banks—by around €63 billion (around 2 percent of banking system assets). Banks' exposure to Italian government securities—of which more than 70 percent are classified as hold-to-maturity—has declined in recent years, but edged up to around 10 percent recently, suggesting that the risk of adverse sovereign-bank feedback persists. Unrealized valuation losses on the entire hold-to-maturity debt securities portfolio are estimated at 200 basis points of CET1 ratio, and have been limited by the much shorter average maturity of government bond holdings than of issued government securities and the use of interest rate hedges. Potential losses on banks' loan books are cushioned by public guarantees (with government exposure equal to about 25 percent of NFC loans at end-2022) extended to mitigate the impacts of the pandemic and the energy crisis.

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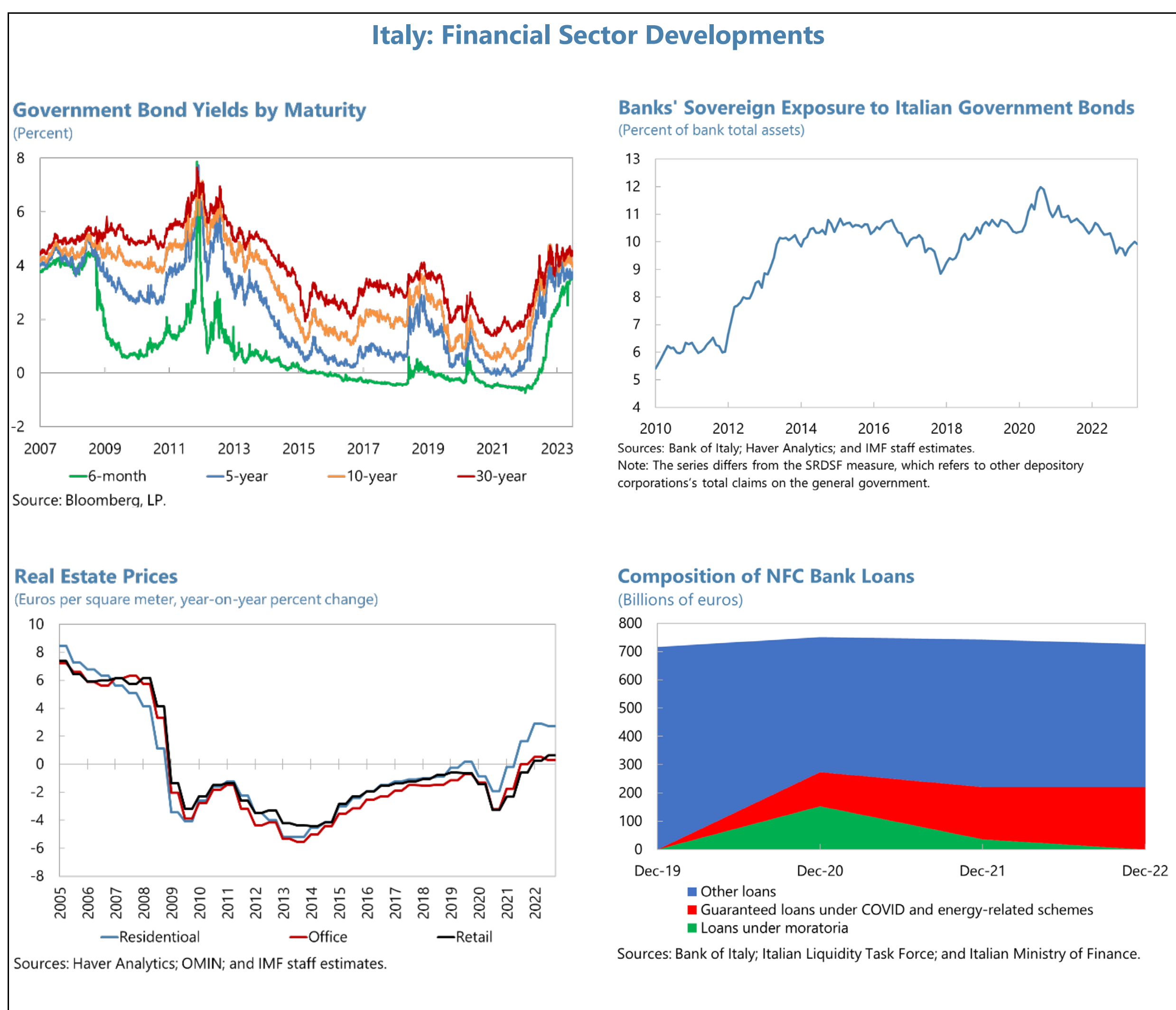

Staff's Views

21. Rising policy interest rates, quantitative tightening, and the economic slowdown have raised stability risks in the financial sector. Banks' capital and liquidity buffers remained broadly stable at comfortable levels over the past year and NPLs declined further. Higher net interest income and release of some provisions accumulated during the pandemic boosted banks' return on equity. However, credit volumes are expected to decline further and NPLs are likely to rise as borrowers' repayment capacity is crimped by higher interest rates and slower economic growth. Funding costs are expected to increase further, especially for banks whose excess reserves are smaller than their maturing TLTRO borrowings and those that need to issue securities to meet MREL requirements. Increased competition with the government for retail savings could further raise banks' funding costs. The value of fixed income securities portfolios has declined on rising yields, although hedging strategies by some banks and the relatively short maturity of securities holdings have dampened unrealized losses. Risks are likely distributed unevenly across the financial sector. Pockets of weakness exist among less significant banks (LSIs) that in the aggregate have weaker credit quality, lower provisioning coverage, and larger holdings of sovereign bonds relative to their capital, although risk absorbing capacity is strengthened by the

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temporary rise in net interest margins. Insurance companies have seen increased surrenders of life insurance policies, declines in premium income, and unrealized losses on securities holdings. Although solvency remains solid, risks to the sector exist amid large exposure to Italian sovereign bonds and the availability of higher-yielding alternative savings instruments. While Italian real estate investment funds (REIFs) are mostly closed-end, mitigating risks of sharp real estate price corrections, spillovers to banks from more pronounced price downturns are possible through their exposure to CRE collateral.

22. Ensuring financial sector resilience to a more restrictive environment is essential. Close attention should continue to be given to individual banks' funding plans, adequacy of their forward-looking liquidity buffers after TLTRO repayments, and the feasibility of using interest rate swaps to bridge duration risk. Stress tests for all banks should continue to be tailored to capture plausible credit, duration, and liquidity risks, including from concentrated yet potentially more volatile funding and sovereign exposures. Calibrating capital and liquidity buffers and challenging banks' dividend and share buyback plans on the basis of the stress test results would ensure adequate headroom is preserved. In this regard, the more comprehensive supervision of LSIs in recent years, accompanied by higher capital requirements and guidance—in line with the 2020 Financial Sector Assessment Program (Annex V)—is welcome. Lending to CRE should continue to receive close attention given the sector's vulnerability amid the post-pandemic increase in remote work. With sizable and riskier exposure to CRE, whose prices have been declining for most of the past decade, completing data collection on current price loan-to-value on an individual loan basis is important for assessing risk in this segment. Risks of a disorderly price correction in residential real estate appear lower than in some other EU countries due to subdued historical price developments.[15] Reinforcing the macroprudential framework could be considered by allowing a positive neutral rate for the countercyclical capital buffer to strengthen banks' ability to absorb shocks, including those not fully captured by Italy's weak credit cycle. The authorities' decision not to proceed with a windfall tax on bank profits will avoid unintended consequences for credit availability and cost, and financial institutions' ability to withstand shocks that such a tax could create.

23. Employing non-standard financial vehicles to mutualize banking sector costs, whether by the public sector or other banks, should be limited. Public-private partnerships that utilize resources of the Italian banking sector's deposit guarantee scheme or voluntary contributions to prevent bank failures outside of resolution or liquidation should be avoided except in cases with strong prospects for successful rehabilitation (Annex V). Given the current low NPL rate and with sales and securitizations of NPLs continuing even after expiration of the GACS scheme, the bar should be high for its reintroduction. Instead, banks should strengthen their own loan recovery performance. The size of the proposed Guaranteed Loan Action Management (GLAM) scheme, allowing the state-owned asset manager to purchase COVID-era guaranteed and related loans and provide additional financing to beneficiary firms, should be capped at the proposed level of ½ percent of GDP.

Authorities' Views

[15] The April 2023 WEO assessed Italy's housing market risks as one of the lowest among advanced economies, in particular due to households' low outstanding mortgage debt relative to gross disposable income, low share of households owning a home with a mortgage, and low cumulative real house price growth in recent years.

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24. The authorities consider that geopolitical tensions, high inflation and a worsening of the economic outlook are the main risks to Italy's financial stability. Nonetheless, the situation in the banking system has improved significantly over the past decade, including as a result of tightening national supervision and substantial reductions in NPLs. Funding and credit risks, including from CRE exposures, are present and are being scrutinized. Banks' plans for repaying TLTROs are being closely monitored and, in general, banks intend to cover any remaining gap beyond their excess reserves through a combination of bond issuance, central bank financing, term deposits and trimming back their balance sheets. While banks have significant sovereign exposure, the impact on capital of changes in yields is limited as a large part of these holdings is at amortized cost. Moreover, these holdings provide high-quality collateral for refinancing. Recent harmonization of the framework for covered bonds with EU standards provides banks an additional source of long-term funding. CRE is less of a concern in Italy reflecting the moderate average LTV rate at current prices and limited possibilities for early redemptions from REIFs. As regards smaller banks, in recent years, the national authorities have improved their supervisory tools also thanks to cooperation with the SSM, including by using stress-test results to guide capital requirements. Assessments of banks' business models have identified those banks in need of improvement; the assessments have been followed up by targeted supervisory actions entailing, where necessary, the orderly exit from the market of a few banks. Expanding the tools to manage problem banks promptly would limit contagion risk. Provided shareholders and managers forfeit their stakes, a role for nonstandard vehicles financed by other banks and on market terms could therefore be considered. To protect continuity of service delivery, the Bank of Italy is also monitoring the soundness of banks' external loan servicers and IT providers. Given the low NPL rate, there is no need at present for special instruments to support banks in disposing of their NPLs, but the tools have been readied if needed.

D. Structural Priorities

Growth-Enhancing Policies

Background

25. Rapid population aging, low labor force participation, and weak productivity are challenging Italy's pace of economic growth. Prolonged declining—and now very low—birth rates and a recent decrease in net inward migration are forecast to shrink the working-age population by nearly 20 percent over the next 25 years. How this will influence future output depends on the evolution of labor force participation, total factor productivity, and the accumulation of physical and human capital.[16] Underperforming education systems, especially in the South, and a very low wage premium on tertiary qualifications, reflecting low technology adoption by firms,[17] discourages higher education while

[16] An accompanying Selected Issues paper analyzes the impact of Italy's demographic trends on future output and the need to close productivity-related and labor participation gaps vis-à-vis the other large euro area economies to offset the demographic drag on growth.

[17] Pellegrino and Zingales (2017) attribute Italy's low productivity to a trust deficit, whereby small firms tend to hire family members to limit arm's length interactions with the legal system and the public administration, weakening demand for skilled "outside" labor.

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incentivizing emigration of highly-qualified graduates. The prevalence of micro firms and a large informal economy[18] also hold back productivity and create a two-tier economic structure. The post-pandemic NRRP, supported by EU grants and concessional loans totaling around 10 percent of GDP, is a comprehensive package of structural reforms and investments aimed at addressing Italy's growth challenges and modernizing the economy (Annex VII). Implementation of the Plan (which runs during 2021-26) is ongoing, but at a slower-than-envisaged pace, which has delayed release of the third payment tranche, and some revisions to the Plan are expected.

Staff's Views

26. Prompt implementation of an ambitious, comprehensive reform agenda is essential to lift productivity and boost potential growth. NRRP reforms are directed at modernizing public administration and the judiciary, simplifying civil procedures, strengthening competition and tax compliance, and improving educational outcomes.[19] Progress with reforms has been made, but the benefits will accrue once they have been completed. Public investment is being held back by labor shortages, rising costs, and the vast number of projects that small municipalities are expected to administer. In contrast, tax credits in support of private investment are performing well, due in part to their generosity. Improving the administrative and execution capacity of small municipalities would reduce public investment bottlenecks, including by making available "off-the-shelf" design plans and tender contracts for small standardized projects. Reducing the number of individual projects that some small municipalities are expected to execute could be considered in order to improve the overall quality of project implementation. Addressing labor shortages and the low activity rate calls for reducing social benefit and tax traps, decreasing informality, providing sufficient affordable child- and elder-care, and looking to foreign workers to fill domestic skill shortages.

[18] ISTAT estimates the underground and illegal economy in Italy accounts for 11 percent of GDP. Informal firms tend to stay small in order to conceal business activity from the tax authorities, and have less incentive to invest in the modernizing production. Thus, they tend to drag down employment and productivity growth.

[19] See Annex IV of the 2022 Article IV staff report for a summary of reforms and investments in the NRRP.

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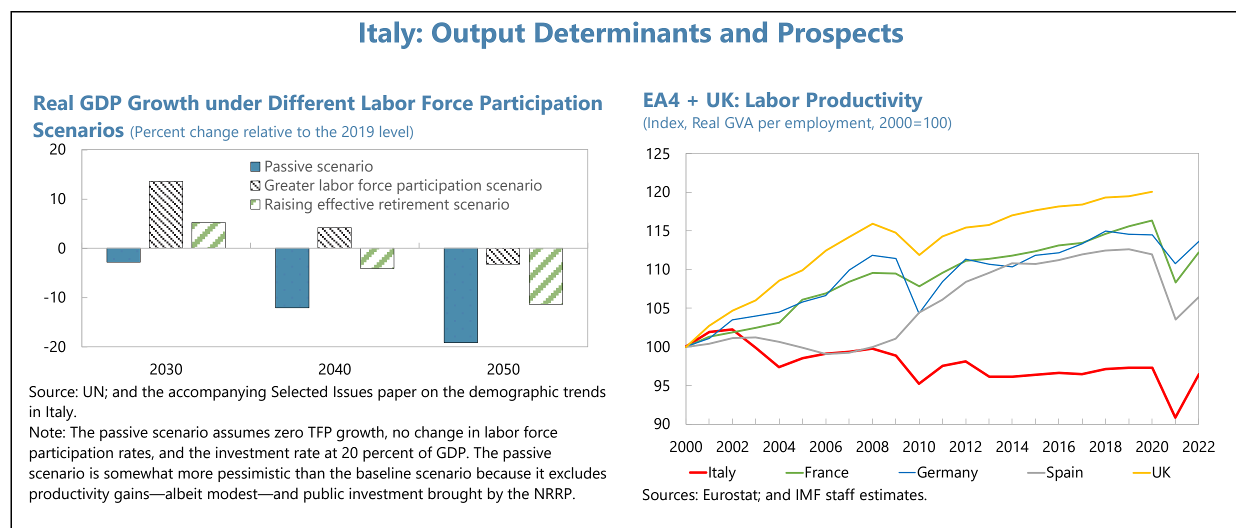

27. Ongoing efforts to strengthen the AML/CFT regime, tackle transnational corruption of public officials and protect the integrity of public resources should continue (Annex VIII). The dedicated AML Supervision and Regulatory Team established within the BdI allows for more efficient handling of the complex and cross-border dimensions of financial crimes. Italy has also made considerable progress in fighting foreign bribery, while risks arising from virtual assets are subject to a new, though yet to be effectively implemented, regulation. However, further action is required to operationalize the new beneficial ownership register. Italy should also strengthen coordination efforts between various agencies involved in detection and pursuance of financial crimes. Administrative and legal measures adopted to speed up NRRP implementation should not erode competition or transparency of contracting, and public officials should be appropriately qualified to assume their legal responsibilities in decision making.

Authorities' Views

28. The authorities will seek to amend the NRRP to better reflect updated priorities. All targets and milestones for 2022 were successfully met. At the same time, the energy crisis and high inflation have created the need for some remodulation and refocusing to accommodate new energy security priorities and account for higher inflation. Consistent with the priority afforded the Plan, oversight has been shifted to the Prime Minister's office and the Government is now finalizing proposed revisions to the Plan and preparing a new REPowerEU chapter. Investments and reforms underway are expected to improve educational outcomes, particularly at the tertiary level, in order to increase young people's employment prospects. Reducing the gender gap in employment and raising social inclusion and preventing marginalization are priorities. The NRRP is also expected to strengthen territorial cohesion. Italy will continue to make timely progress in further reinforcing its AML/CFT framework.

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Energy Security and Transition

Background

29. Italy successfully met its energy needs for winter 2022–23, although at high prices, and progress with reducing carbon emissions is slow. Mild temperatures, a slowdown of energy-intensive production, subsidies for storage, diversification of gas supplies, and increased use of coal all contributed. Recently-agreed purchase contracts are expected to allow Italy to meet the EC's gas storage target of 90 percent capacity by October. However, a combination of negative shocks—full shut-off of Russian gas, more resilient gas demand, and a continued drought that limits hydro-generated electricity—could lead to shortages. Electricity generation from renewables was at a 10-year low in 2022 reflecting the drought-induced reduction in hydroelectricity, despite a modest increase in solar and wind capacity.[20] Measures introduced last year to fast-track installation of renewables have done little to reduce the long pipeline of projects awaiting permits. Despite some simplifications, a long and complex chain of permits is required, with some cases requiring more than 30 approvals. To achieve the target of reducing carbon emissions by 55 percent of 1990 levels by 2030, Italy's emissions would need to be nearly halved. The forthcoming 2030 Electricity Plan is expected to target connecting 85 GW of new renewables to the electricity grid and creating 80 GWh of new large-scale storage capacity.

Staff's Views

30. Accelerating the transition to renewables would strengthen energy security and support attainment of Italy's climate goals. Preparing for possible adverse shocks to energy supply in the coming winter is advised, including by ensuring the timely commencement of operations of the new floating storage and regassification facilities. Full return to market-based energy pricing would encourage further efficiency gains and conservation and a faster shift to renewable energy. Streamlining the extensive approvals procedures that continue to delay new renewable energy projects is essential to avoid deterring potential investors and to meet ambitious targets. New energy-related contracts should avoid locking Italy into long-term fossil fuel dependence. Replacing excise taxes on electricity with carbon taxes on input fuels would encourage green power generation. The Superbonus scheme should be amended to sharply reduce the subsidy rate and limit eligible investments to those that deliver significant improvements in energy efficiency, while embedding mandatory green standards in building codes. Investing in complementary renewable energy infrastructure, including energy storage and distribution networks, is also key. Ample scope exists to reduce industrial emissions by bringing lagging firms to the emissions levels of their better-performing sectoral peers.[21] In addition, taxes on energy should be based on their carbon content and carbon taxes should be equalized across fuels and sectors.

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[20] Italy added 3GW of renewable capacity in 2022, increasing total renewable capacity to 61 GW, almost exclusively through new plants, with 2.5 GW coming from solar plants.

[21] Italy 2022 Article IV - Selected Issue paper, "Securing a Smooth Green Transition" and an accompanying Selected Issues paper discuss strategies for achieving Italy's climate goals.

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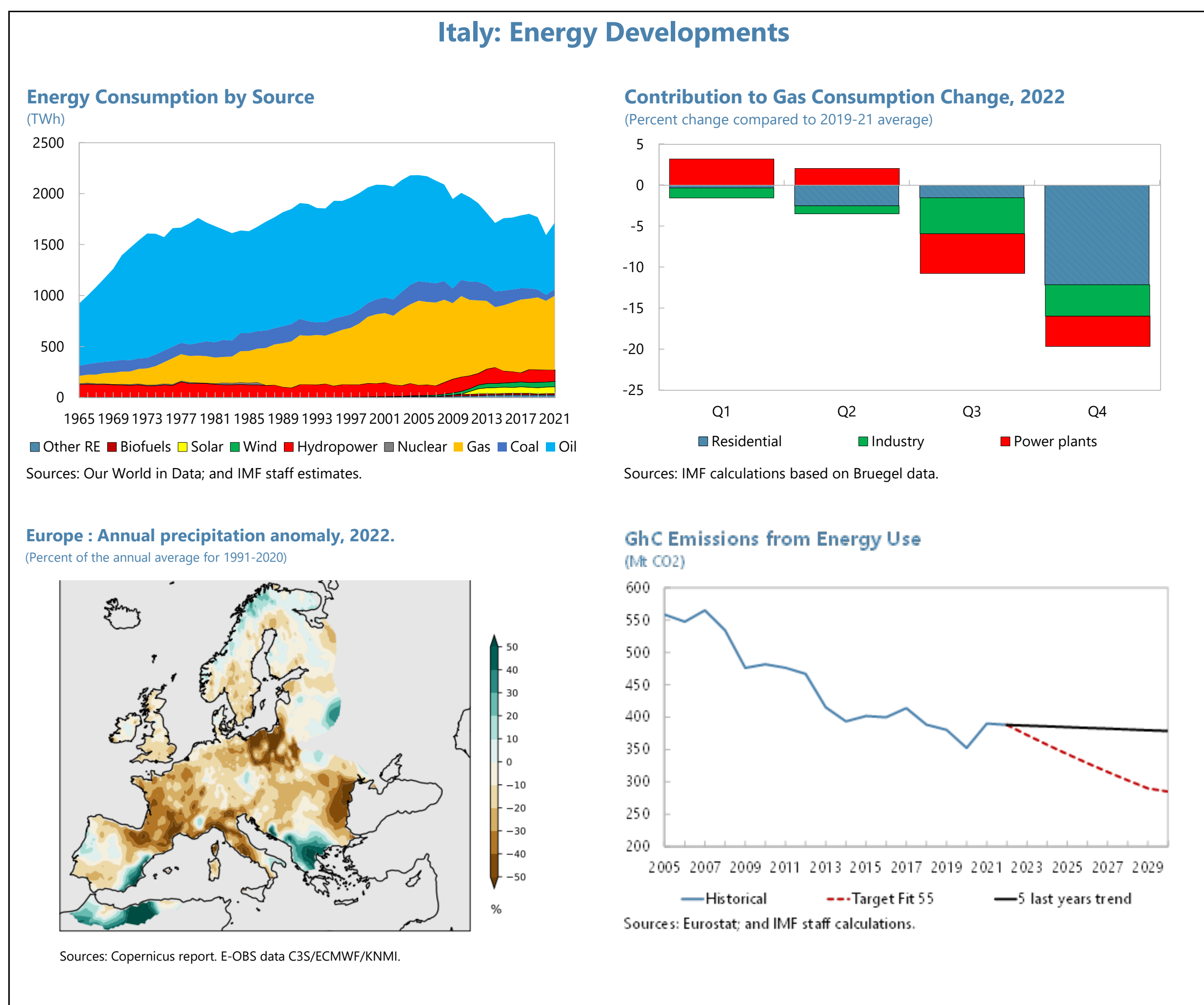

Authorities' Views

31. The authorities consider the outlook for energy security to be much improved from a year ago and remain committed to achieving their climate goals. Risk of a sizable gas shortage is low given the historically-high level of storage in the spring months. Nonetheless, competition for gas supplies in advance of next winter could temporarily cause prices to rebound, although coordinated purchasing at the EU level would temper this risk. Gas supply disruption caused by the war in Ukraine slowed emissions reduction by requiring a shift to more carbon-intensive fuels. However, recent energy efficiency mandates, including minimum cooling and maximum heating settings, have been successful and will remain in place. The Superbonus scheme will expire at end-2025, and subsidy rates will continue to decline in the interim. Decisions on carbon pricing will be made in the context of the EU's pending revision to the Energy Taxation Directive. To tackle authorization bottlenecks for renewable electricity, an upcoming decree will provide greater autonomy to regions for approvals and encourage better coordination among ministries. A specific structural challenge for renewable energy in Italy is that conditions for solar generation are most favorable in the south of the country while demand is highest in the north; electricity grid investments, to be deployed in the next years, should tackle this issue. The draft

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REPowerEU chapter aims to strengthen energy autonomy and environmental transition by improving the grid, increasing production from renewable sources, supporting the decarbonization of companies, and encouraging energy-related production chains.

STAFF APPRAISAL

32. The Italian economy has demonstrated resilience amid sequential adverse shocks, but major structural challenges remain. Output and employment recovered strongly in 2021 and 2022, private sector financial positions have strengthened, and households and firms have adapted to the sharp increase in energy prices. Skillful management of gas supplies avoided energy shortages, extensive compensation cushioned the impact of higher energy prices on real purchasing power, while generous tax credits boosted construction. Still-low real interest rates amid ample liquidity supported credit growth and loan quality. However, the fiscal deficit widened sharply, the public debt ratio declined but remains very high, and core inflation has yet to slow decisively. The external position in 2022 was weaker than warranted by medium-term fundamentals, although the corresponding uncertainty is high. In the absence of deep structural reforms and a large increase in employment, persistent weak productivity would be compounded by a shrinking working-age population, raising the burden of public debt.

33. Growth is expected to slow as energy prices stabilize at a higher "new normal" level and exceptional policy support is withdrawn, while risks are mainly to the downside. Growth is expected to moderate to around 1 percent this year and next, significantly below the high "bounce-back" rates of the past two years, but higher than before the pandemic reflecting the stronger labor market and continued tapping of accumulated savings. Spending under the National Recovery and Resilience Plan is forecast to increase and temporarily push up growth around the middle of the decade. Underlying inflation is likely to prove sticky given propagation through the wage settlement system and ongoing fiscal support for the cost of living shock. However, a sharply tighter monetary policy could trigger funding tensions and with moderate, but borderline, overall risk of sovereign stress and strong sovereign-bank-corporate linkages, Italy could be disproportionately affected. Fragmenting economic relations with other regions could impede access to markets and critical inputs. Modest positive growth surprises are possible, but a robust increase in growth prospects requires comprehensive reforms and investments.

34. Reinforcing public finances is now essential to decisively lower the debt ratio, create room for critical modernizing spending and prepare for future shocks. Italy's overall risk of sovereign stress is moderate, but—with a borderline assessment for the medium-term horizon and high risk for the long-term horizon—the overall rating is sensitive to high uncertainty on assumptions and small policy deviations. Fiscal deficits are forecast to decline only gradually, with initial progress from unwinding remaining crisis support. However, continuing to improve fiscal balances will require increasing effort as higher aging-related costs set in. Greater frontloading of adjustment is advised, also to moderate price pressures and mitigate risks of sovereign stress amid slower growth, tighter financial conditions, strong sovereign-bank linkages, and rising pension spending. Saving revenue windfalls and spending more efficiently could deliver a sizable near-term fiscal improvement. This would allow time to develop and implement well-defined and efficient measures to underpin consolidation, grounded in a medium-term

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fiscal framework. Maintaining a 3 percent of GDP primary surplus and growing primary current spending—including tax expenditures— by at least 1 to 2 percentage points below nominal GDP growth would deliver steady, decisive debt reduction and carve out room for public investment. A tax reform should broaden the base, increase efficiency and equity, and strengthen revenue collection. Public guarantees should be prudently managed and well provisioned, with strict limits on new guarantees.

35. Preserving financial stability is a priority as monetary policy tightening proceeds, while limiting recourse to public-sector backstops. Increased capital and liquidity buffers, strengthened supervisory oversight and the sizable share of guaranteed loans will bolster the banking sector's ability to absorb higher funding costs and the anticipated weakening of loan quality. Strong competition for funding with the public sector could bid up interest rates on bank deposits. Close attention is warranted for those banks whose excess reserves do not cover their concessional longer-term funding from the ECB. Focus is also advised on commercial real estate as well as those smaller banks with weaker business models that could currently be masked by temporarily elevated net interest margins. Adequate headroom on capital and liquidity should be maintained from a forward-looking perspective to absorb potential shocks, with conforming dividend and share buyback plans. The need for public-private partnerships in the banking sector has been greatly diminished in view of the significant strengthening over the past decade, and should generally be avoided.

36. Reforms and investments that grow productivity and modernize the economy are essential to sustainably raise real incomes and meet demographic, energy, climate, and geo-economic fragmentation challenges. The agenda established in the NRRP is appropriately ambitious and aimed at addressing Italy's long-standing impediments to productivity, investment, and labor force participation. Reforms should be adopted fully and bottlenecks to implementing critical investments resolved pragmatically, including through recourse to skilled foreign workers and providing adequate technical guidance to smaller municipalities. Measures to accelerate procedures should promote competition and transparency and protect the integrity of financial resources. To ensure that high execution standards are achieved, it may be necessary to reduce the number of small-scale projects, especially in smaller municipalities that are facing large increases in workload. Accelerating permitting for new renewable electricity capacity would strengthen energy security and support climate targets, in addition to providing more welcoming and predictable conditions for private investors.

37. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.

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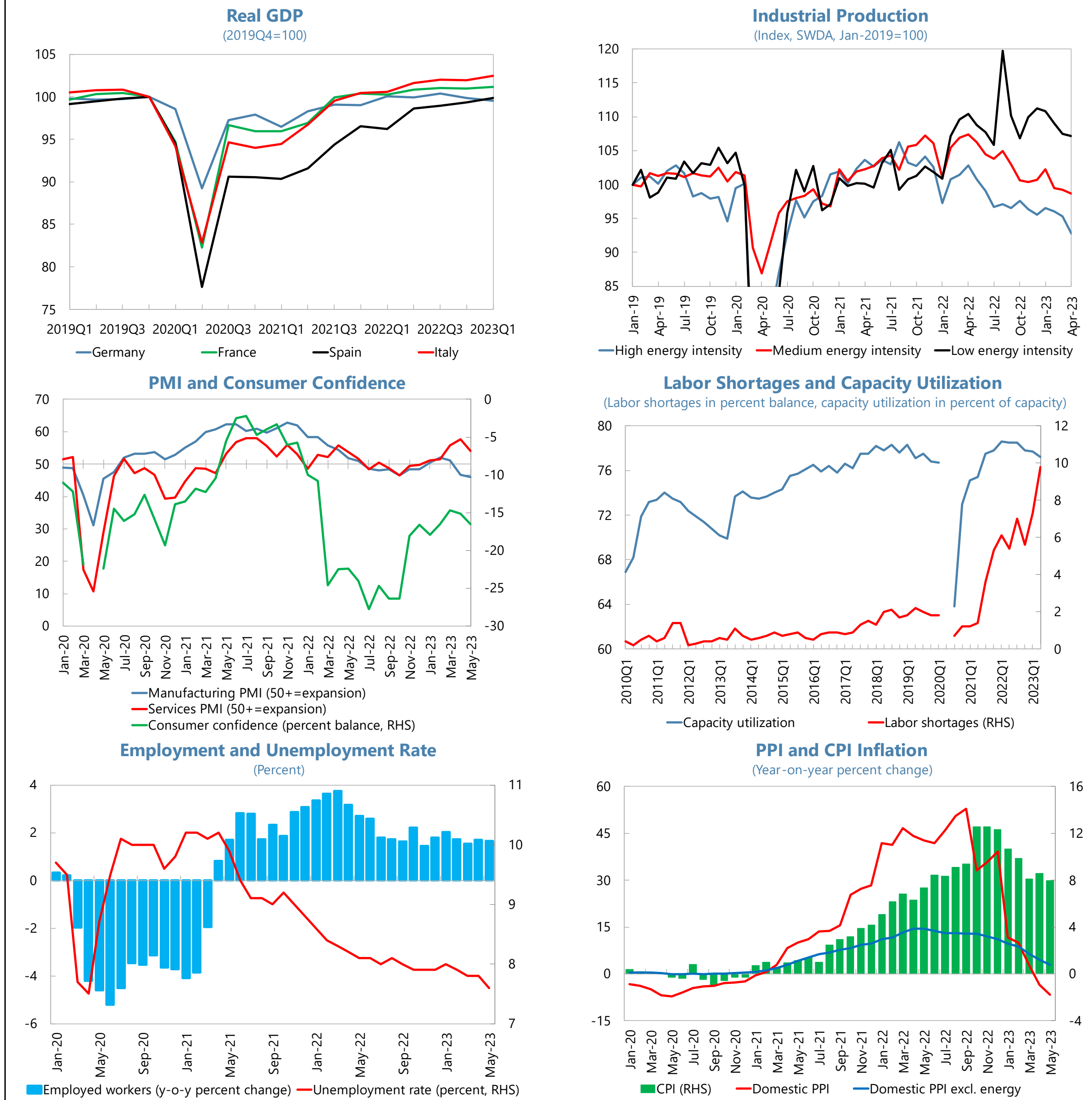

Sources: Haver Analytics; Istat; Bank of Italy; and IMF staff estimates.

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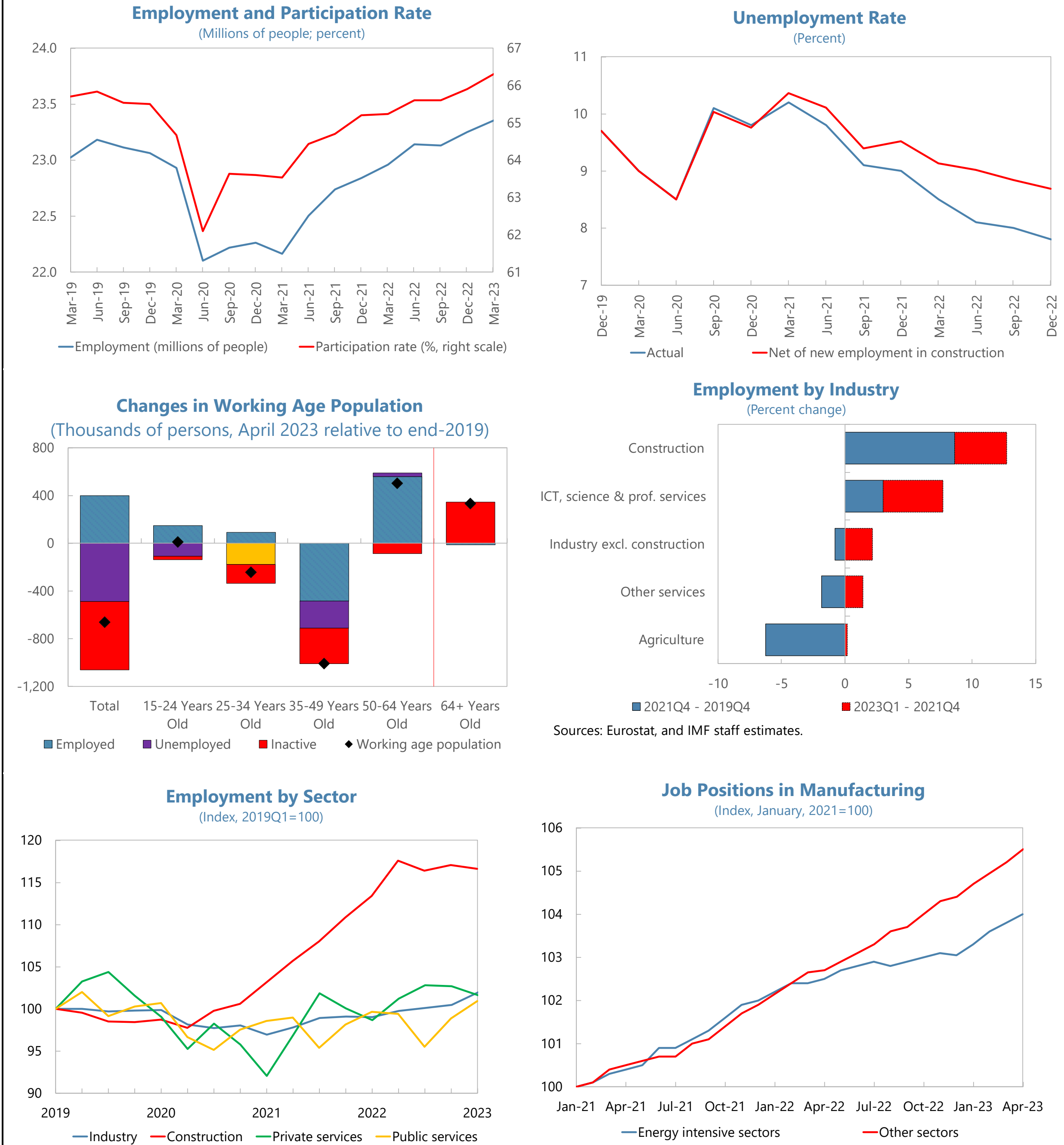

Sources: Haver Analytics; Bloomberg, LP; Istat; Bank of Italy; IMF staff estimates.

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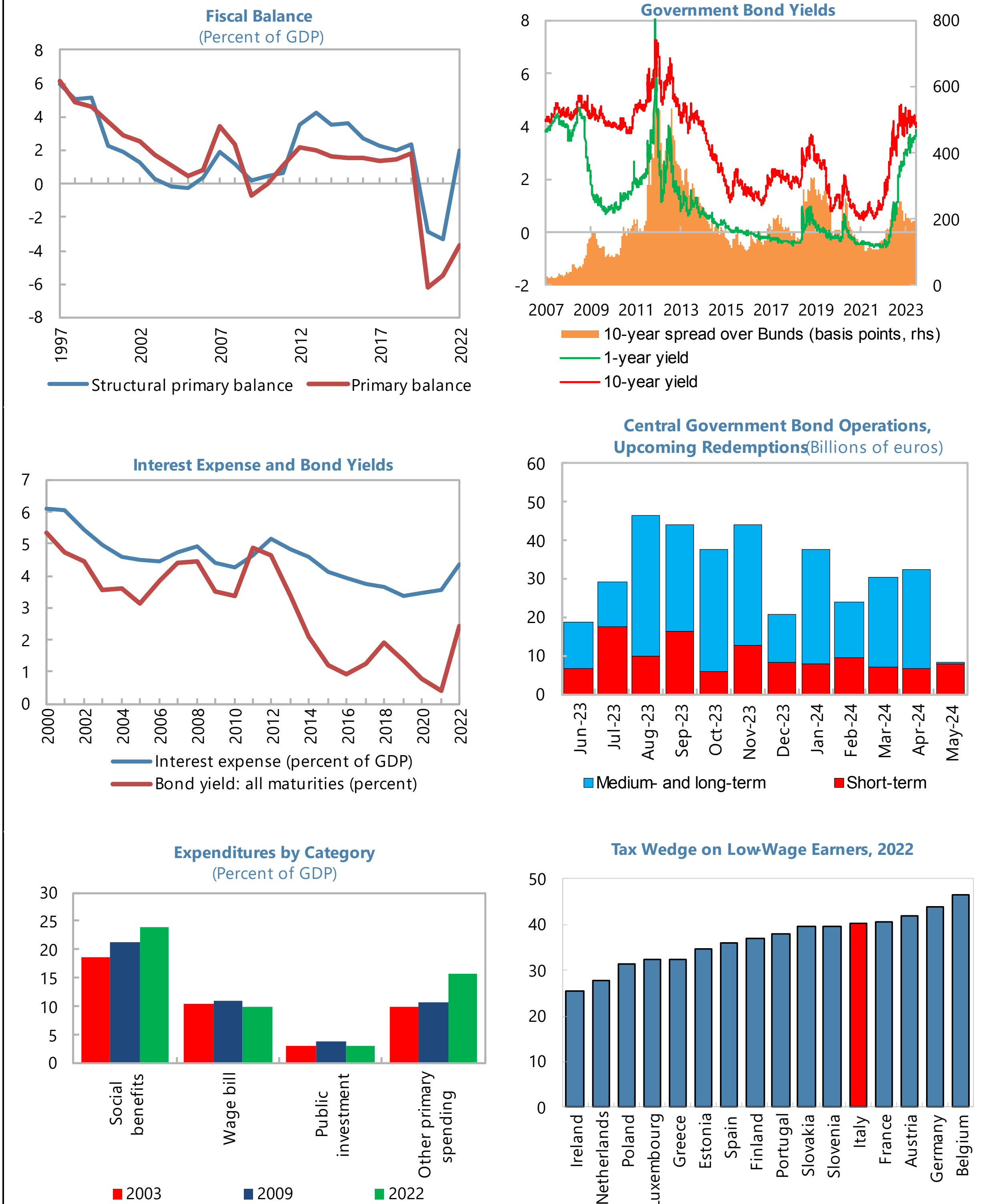

Sources: Haver Analytics; Bloomberg, LP; Istat; Eurostat; Bank of Italy; and IMF staff estimates.

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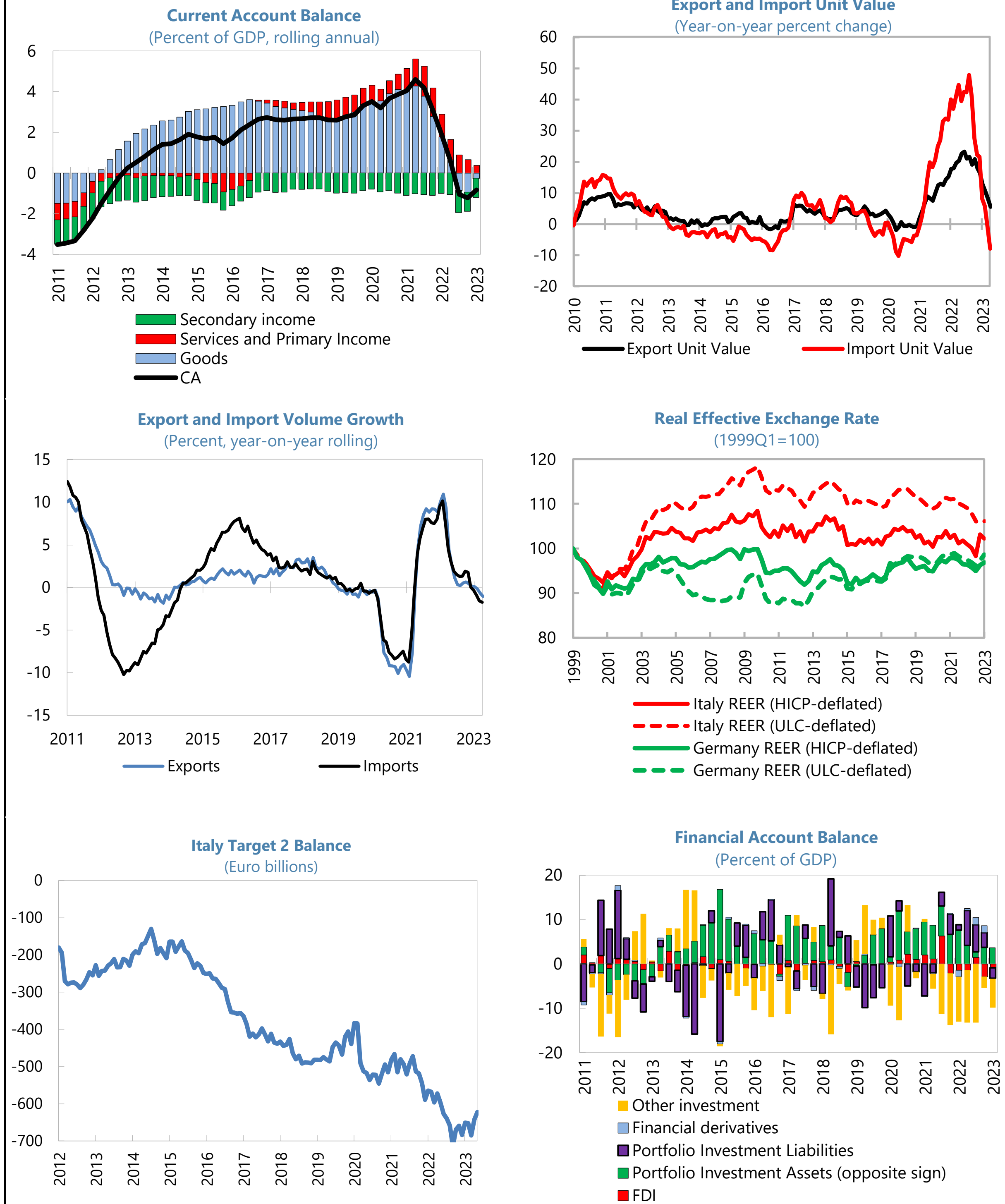
Figure 4. Italy: External Developments



Sources: Haver Analytics; ISTAT; Bank of Italy; IMF staff estimates.

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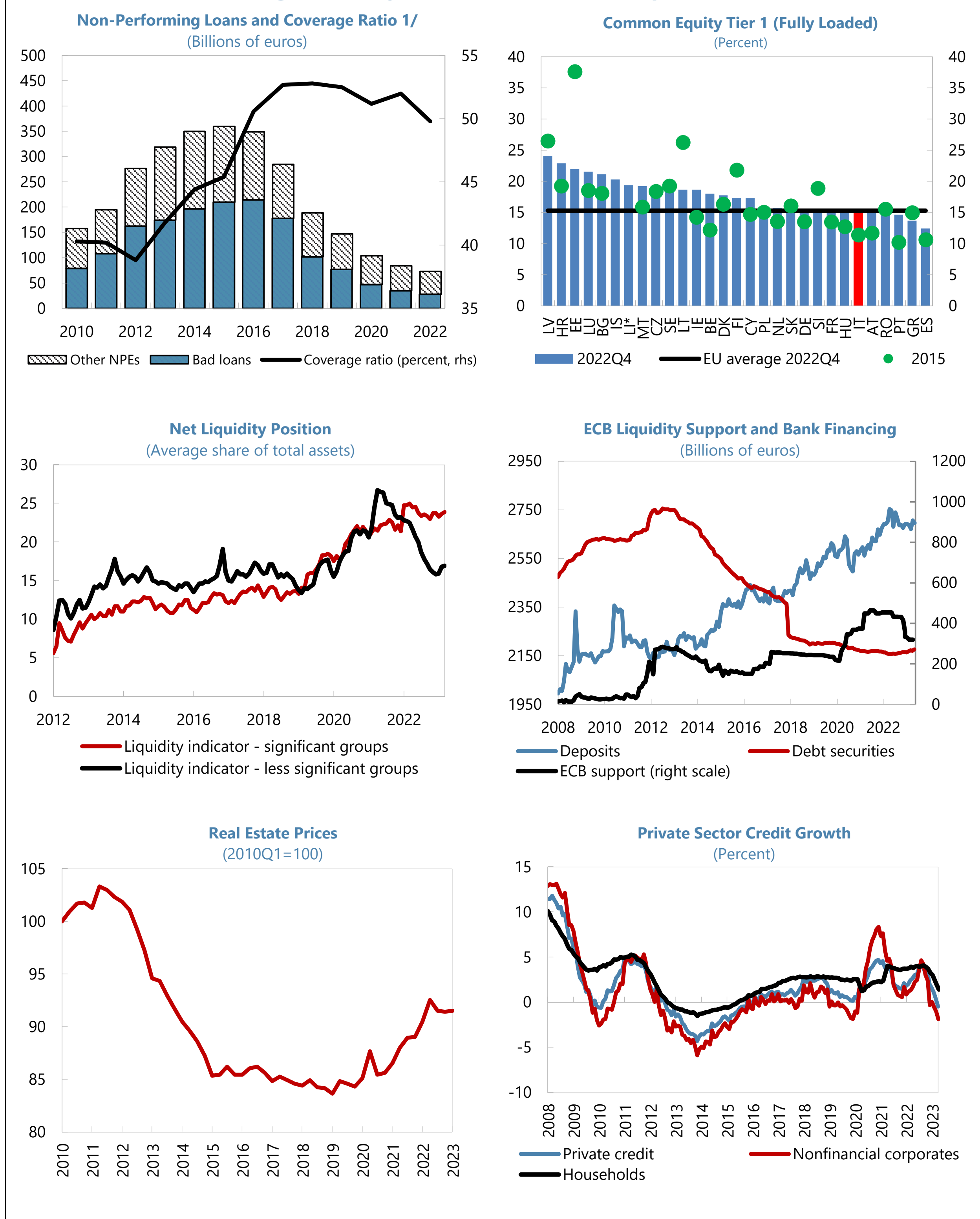

Sources: Haver Analytics; Istat; Bank of Italy; EBA; and IMF staff estimates.

1/ Bank of Italy data starting from 2012.

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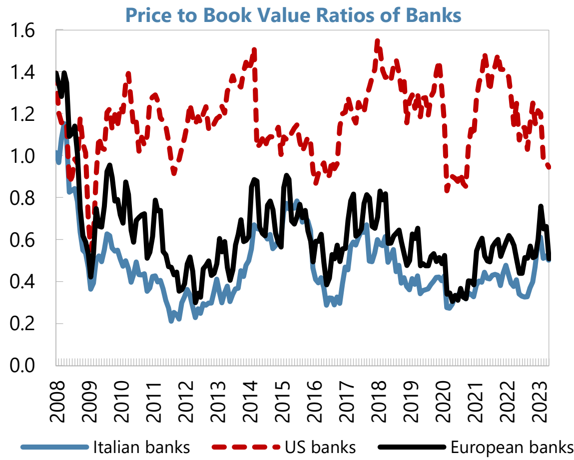
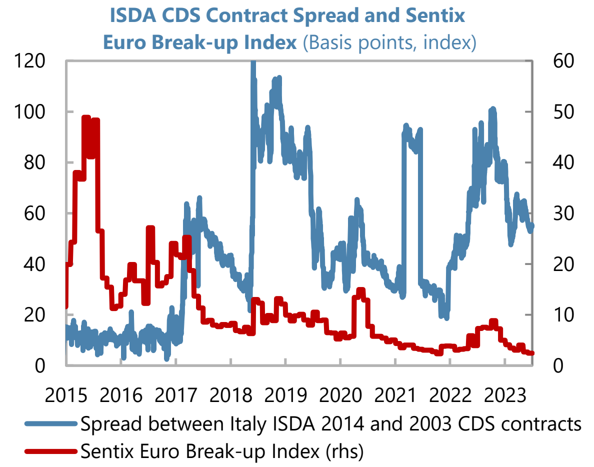
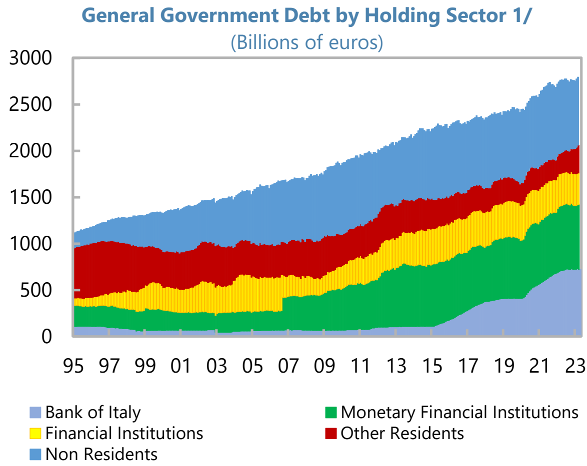
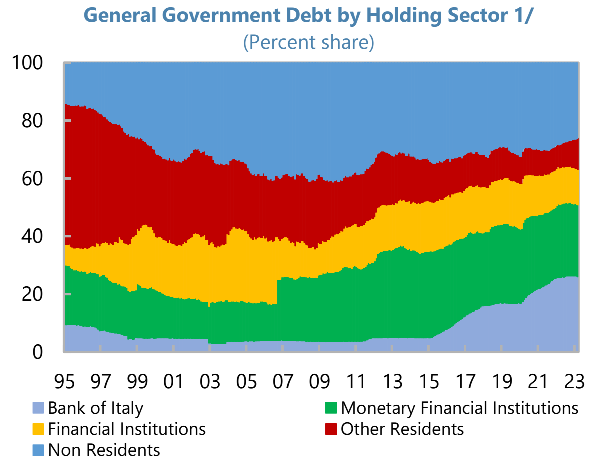
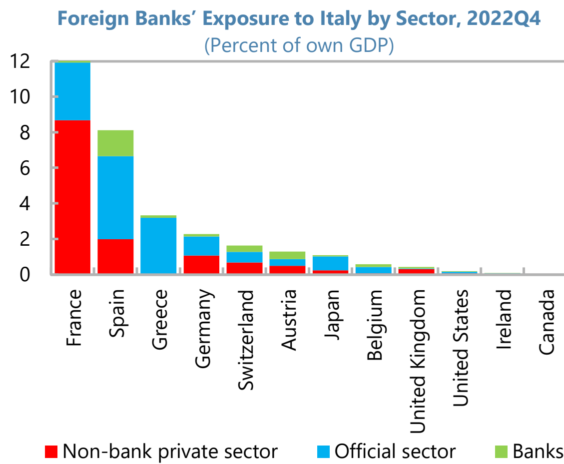
Figure 6. Italy: Financial Sector Assets and Valuation, 2008-23

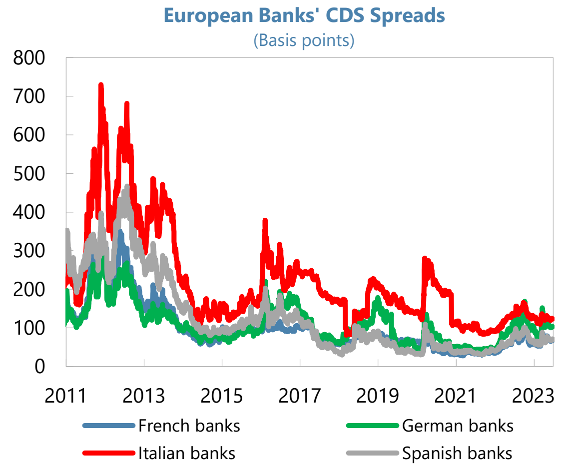












Sources: Haver Analytics; Bloomberg, LP; ISTAT; Bank of Italy; IMF staff estimates.

1/ Debt recorded at face value.

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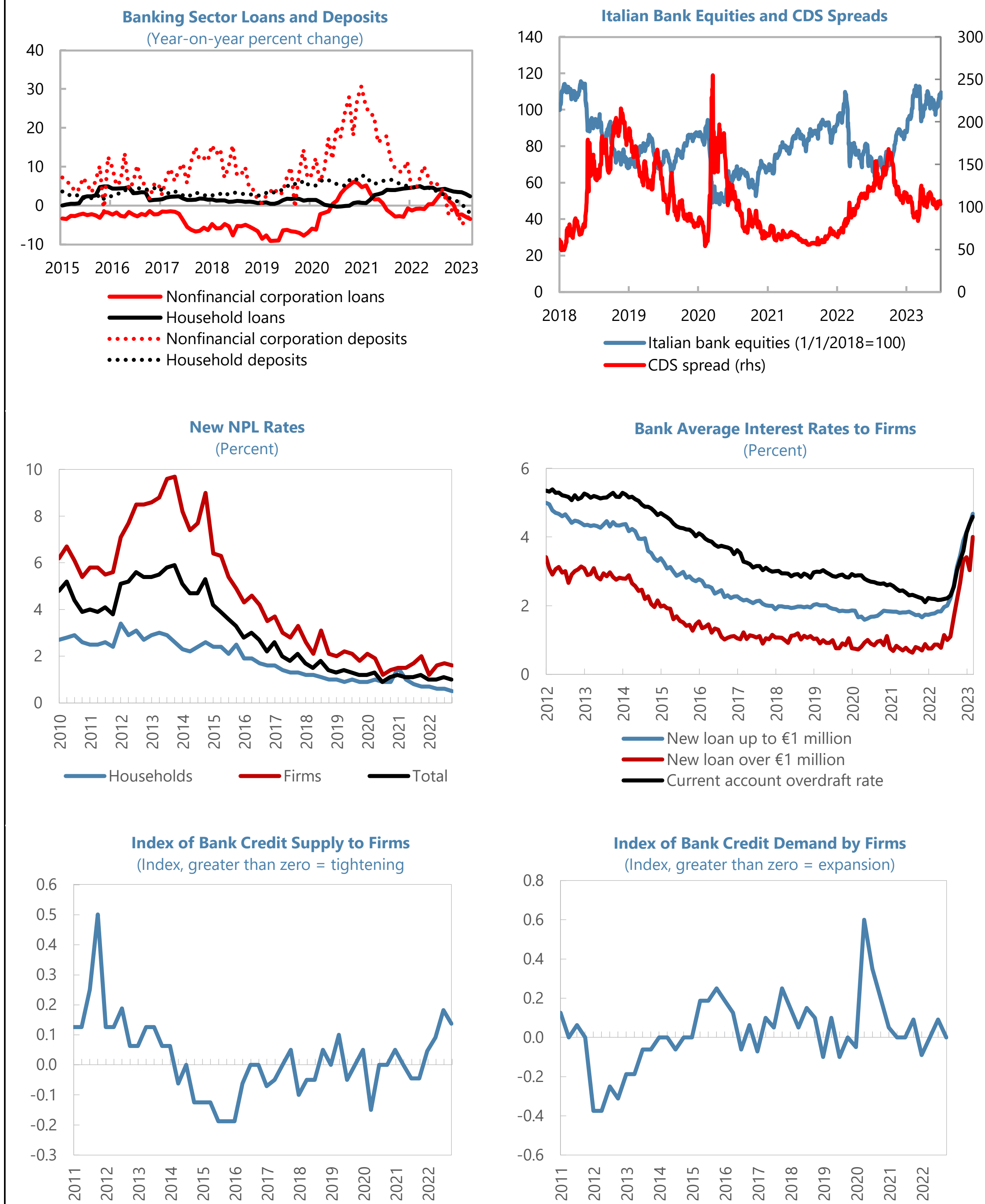

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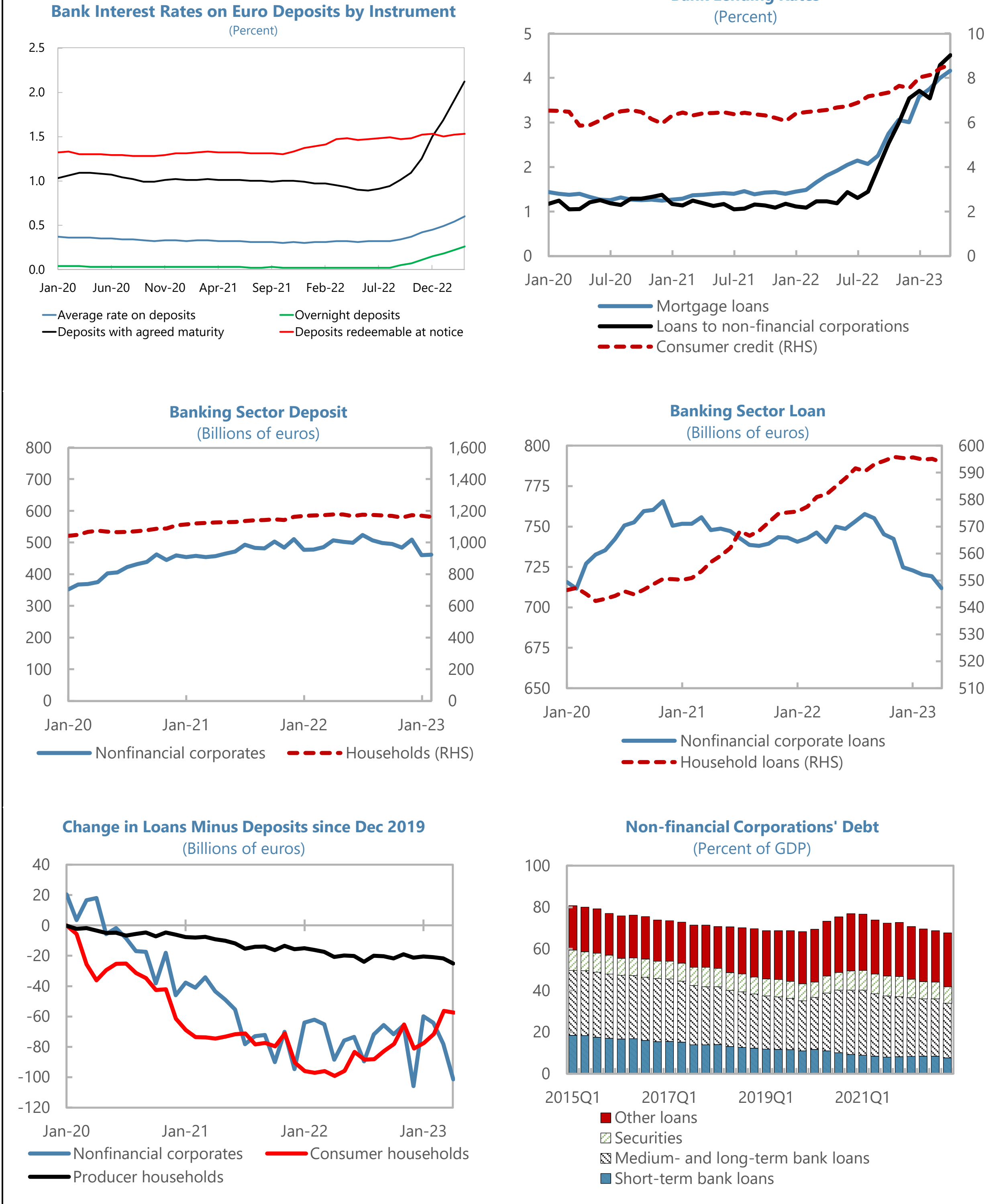

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Table 1. Italy: Summary of Economic Indicators, 2019–28

(Annual percentage change, unless noted otherwise)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
Real GDP	0.5	-9.0	7.0	3.7	1.1	0.9	1.1	1.1	1.0	0.9
Real domestic demand	-0.2	-8.4	7.2	4.3	0.9	1.0	1.2	1.1	1.1	1.0
Final domestic demand	0.2	-8.0	6.6	4.7	1.3	0.8	1.1	1.1	1.1	1.0
Private consumption	0.2	-10.4	4.7	4.6	1.3	1.2	1.1	1.1	0.8	0.7
Public consumption	-0.6	0.0	1.5	0.0	-1.1	-2.2	-1.2	-0.9	1.1	0.9
Gross fixed capital formation	1.2	-7.9	18.6	9.4	3.1	2.2	3.1	2.7	1.8	1.8
Stock building 1/	-0.5	-0.5	0.5	-0.4	-0.3	0.1	0.1	0.0	0.0	0.0
Net exports 1/	0.7	-0.8	0.0	-0.5	0.2	-0.1	-0.1	0.0	0.0	-0.1
Exports of goods and services	1.6	-13.5	14.0	9.4	2.2	2.8	2.7	2.6	2.5	2.3
Imports of goods and services	-0.7	-12.1	15.2	11.8	1.7	3.2	3.1	2.7	2.6	2.6
Savings 2/	21.6	21.6	23.7	20.5	22.2	23.9	24.6	25.2	25.5	25.9
Investment 2/	18.2	17.7	20.7	21.8	21.5	22.9	23.4	23.6	23.7	23.8
Resource utilization										
Potential GDP	0.4	-4.0	4.1	0.0	0.7	0.7	0.9	0.8	0.8	0.9
Output gap (percent of potential)	-1.8	-7.0	-4.3	-0.8	-0.4	-0.3	0.0	0.2	0.4	0.5
Employment	0.7	-3.1	0.8	2.4	0.8	0.1	0.0	0.1	0.1	0.0
Unemployment rate (percent)	9.9	9.3	9.5	8.1	8.0	8.1	8.2	8.2	8.2	8.3
Prices										
GDP deflator	0.9	1.6	0.6	3.0	6.2	3.6	2.2	2.0	2.0	2.0
Consumer prices	0.6	-0.1	1.9	8.7	5.2	2.5	2.2	2.0	2.0	2.0
Consumer prices (core)	0.6	0.5	0.8	4.0	4.8	3.2	2.2	2.0	2.0	2.0
Hourly compensation 3/	2.9	5.1	-1.8	3.2	4.5	2.5	2.3	2.1	2.1	2.3
Productivity 3/	0.5	0.8	1.4	-0.9	0.2	0.7	1.3	1.1	1.1	1.2
Unit labor costs 3/	2.4	4.4	-3.1	4.1	4.3	1.8	1.0	1.0	1.0	1.1
Fiscal indicators										
General government net lending/borrowing 2/	-1.5	-9.7	-9.0	-8.0	-4.5	-3.4	-2.8	-2.3	-2.3	-2.3
General government primary balance 2/ 4/	1.9	-6.2	-5.5	-3.6	-0.5	0.8	1.4	2.0	2.0	2.0
Structural overall balance (percent of potential GDP)	-0.6	-5.4	-4.6	-1.7	-2.1	-2.9	-3.1	-2.5	-2.6	-2.6
Structural primary balance (percent of potential GDP) 4/	2.7	-2.2	-1.2	2.7	1.9	1.2	1.1	1.8	1.7	1.7
General government gross debt 2/	134.1	154.9	149.9	144.4	140.5	138.8	138.1	137.2	136.3	135.6
Exchange rate regime				Member of the EMU						
Exchange rate (national currency per U.S. dollar)	0.9	0.9	0.8	0.9	...	...	...	...	...	...
Nominal effective rate: CPI based (2000=100)	103.0	105.2	106.4	104.6	...	...	...	...	...	...
Financial sector										
Bank loans to the private sector (change in percent of GDP)	-2.4	2.8	1.0	0.1	-2.0	-1.0	0.0	1.0	1.0	1.0
External sector 2/										
Current account balance	3.3	3.9	3.1	-1.2	0.7	0.9	1.2	1.5	1.8	2.0
Trade balance	3.4	3.6	2.3	-1.4	0.5	0.7	1.0	1.3	1.6	1.8
Capital account balance	-0.1	0.1	0.1	0.5	0.8	0.8	0.7	0.4	0.0	0.0

Sources: National Authorities; and IMF staff estimates.

1/ Contribution to growth.

2/ Percent of GDP.

3/ In industry (including construction).

4/ Primary revenue minus primary expenditure.

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Table 2. Italy: Statement of Operations–General Government (GFSM 2001 format), 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
					(Billions of euros)					
Revenue	843.8	786.3	863.4	931.4	1,000.6	1,015.9	1,045.7	1,069.8	1,096.0	1,120.4
Taxes	517.0	478.8	529.4	568.6	609.8	625.1	642.4	659.4	678.7	697.3
Social contributions	242.2	229.7	246.1	261.0	277.8	293.7	302.5	309.8	316.6	321.8
Grants	3.0	4.5	9.0	20.0	22.8	11.8	11.8	4.7	3.0	4.0
Other revenue	81.6	73.3	78.9	81.8	90.2	85.3	89.0	95.8	97.7	97.2
Expenditure	870.9	946.7	1,024.6	1,083.3	1,093.5	1,088.3	1,107.7	1,122.7	1,150.8	1,176.3
Expense	870.4	946.1	1,023.8	1,082.4	1,093.4	1,088.2	1,107.6	1,122.6	1,150.7	1,176.2
Compensation of employees	172.9	173.2	176.8	186.9	192.5	192.7	191.9	192.9	200.8	206.8
Use of goods and services	101.2	102.9	110.3	115.2	113.5	114.9	118.3	119.8	125.0	129.6
Consumption of fixed capital	49.1	49.5	51.3	54.7	65.1	70.0	71.8	75.3	70.7	67.7
Interest	60.4	57.3	63.7	83.2	83.4	88.8	93.6	98.1	101.7	104.6
Social benefits	406.9	445.3	445.7	457.7	479.1	498.7	514.8	526.2	540.3	552.6
Other expense	79.8	117.9	176.0	184.7	159.8	123.1	117.2	110.4	112.3	114.9
Net acquisition of nonfinancial assets	0.5	0.6	0.8	0.9	0.1	0.1	0.1	0.1	0.1	0.1
Net lending/borrowing	-27.1	-160.4	-161.2	-151.9	-92.9	-72.4	-62.0	-52.9	-54.9	-55.9
					(Percent of GDP, unless otherwise indicated)					
Revenue	47.0	47.3	48.3	48.8	48.8	47.4	47.2	46.9	46.6	46.3
Taxes	28.8	28.8	29.6	29.8	29.7	29.2	29.0	28.9	28.8	28.8
Social contributions	13.5	13.8	13.8	13.7	13.6	13.7	13.7	13.6	13.5	13.3
Grants	0.2	0.3	0.5	1.0	1.1	0.6	0.5	0.2	0.1	0.2
Other revenue	4.5	4.4	4.4	4.3	4.4	4.0	4.0	4.2	4.2	4.0
Expenditure	48.5	57.0	57.3	56.7	53.3	50.8	50.0	49.2	48.9	48.6
Expense	48.4	57.0	57.3	56.7	53.3	50.8	50.0	49.2	48.9	48.6
Compensation of employees	9.6	10.4	9.9	9.8	9.4	9.0	8.7	8.4	8.5	8.5
Use of goods and services	5.6	6.2	6.2	6.0	5.5	5.4	5.3	5.2	5.3	5.4
Consumption of fixed capital	2.7	3.0	2.9	2.9	3.2	3.3	3.2	3.3	3.0	2.8
Interest	3.4	3.5	3.6	4.4	4.1	4.1	4.2	4.3	4.3	4.3
Social benefits	22.6	26.8	24.9	24.0	23.4	23.3	23.3	23.0	23.0	22.8
Other expense	4.4	7.1	9.8	9.7	7.8	5.7	5.3	4.8	4.8	4.7
Net acquisition of nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending/borrowing	-1.5	-9.7	-9.0	-8.0	-4.5	-3.4	-2.8	-2.3	-2.3	-2.3
Memorandum items:										
Primary balance 1/	1.9	-6.2	-5.5	-3.6	-0.5	0.8	1.4	2.0	2.0	2.0
Structural primary balance 1/	2.7	-2.2	-1.2	2.7	1.9	1.2	1.1	1.8	1.7	1.7
Change in structural primary balance 2/	0.4	-5.0	1.1	3.8	-0.7	-0.7	-0.1	0.7	-0.1	0.0
Structural balance 2/	-0.6	-5.4	-4.6	-1.7	-2.1	-2.9	-3.1	-2.5	-2.6	-2.6
Change in structural balance 2/	0.7	-4.9	0.9	2.9	-0.5	-0.8	-0.2	0.6	-0.1	0.0
General government gross debt	134.1	154.9	149.9	144.4	140.5	138.8	138.1	137.2	136.3	135.6

Sources: National Authorities; and IMF staff estimates.
1/ Primary revenue minus primary expenditure.
2/ Percent of potential GDP.

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Table 3. Italy: Summary of Balance of Payments, 2019–28

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
	(Billions of euros)									
Current account balance	59.5	64.0	54.9	-23.3	13.4	19.3	25.9	34.1	41.7	48.6
Balance of goods and services	60.3	59.9	40.6	-27.6	10.1	16.0	22.4	30.4	37.9	44.5
Goods balance	60.7	68.3	49.7	-18.1	12.1	18.1	24.6	32.7	40.2	47.0
Exports	459.0	414.5	496.5	591.4	611.2	646.3	678.4	708.1	732.0	754.3
Imports	398.2	346.3	446.8	609.5	599.1	628.2	653.8	675.5	691.8	707.3
Services balance	-0.4	-8.4	-9.1	-9.6	-2.0	-2.1	-2.2	-2.3	-2.4	-2.4
Credit	109.4	74.5	87.8	121.6	114.8	120.0	124.0	127.9	131.8	135.6
Debit	109.8	82.9	96.9	131.1	116.8	122.1	126.2	130.1	134.1	138.0
Primary income balance	14.8	20.7	34.1	22.3	21.8	22.6	23.4	24.2	25.0	25.8
Credit	76.9	63.7	81.9	76.9	80.3	83.9	86.7	89.5	92.3	95.0
Debit	62.2	42.9	47.9	54.6	58.6	61.2	63.3	65.2	67.3	69.2
Secondary income balance	-15.6	-16.6	-19.7	-17.9	-18.5	-19.3	-19.9	-20.6	-21.2	-21.8
Capital account balance	-1.2	0.9	1.0	10.3	17.4	17.5	15.5	9.5	1.2	1.2
Financial account	52.9	72.2	55.3	-17.6	30.8	36.8	41.4	43.6	42.9	49.8
Direct investment	1.5	18.8	31.2	-20.7	-10.2	-10.7	-11.0	-11.2	-11.5	-11.8
Portfolio investment	-50.2	115.9	123.1	167.2	-23.5	-20.6	-12.3	-9.8	-9.7	-14.2
Other investment	95.7	-64.0	-119.7	-177.4	58.6	64.9	62.8	63.6	63.4	75.1
Derivatives (net)	2.7	-2.5	0.0	11.4	5.9	3.2	1.8	1.1	0.8	0.6
Reserve assets	3.2	4.0	20.7	2.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-5.4	7.2	-0.7	-4.6	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)									
Current account balance	3.3	3.9	3.1	-1.2	0.7	0.9	1.2	1.5	1.8	2.0
Balance on goods and services	3.4	3.6	2.3	-1.4	0.5	0.7	1.0	1.3	1.6	1.8
Goods balance	3.4	4.1	2.8	-0.9	0.6	0.8	1.1	1.4	1.7	1.9
Services balance	0.0	-0.5	-0.5	-0.5	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Primary income balance	0.8	1.2	1.9	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Secondary income balance	-0.9	-1.0	-1.1	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Capital account balance	-0.1	0.1	0.1	0.5	0.8	0.8	0.7	0.4	0.0	0.0
Financial account	2.9	4.3	3.1	-0.9	1.5	1.7	1.9	1.9	1.8	2.1
Direct investment	0.1	1.1	1.7	-1.1	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Portfolio investment	-2.8	7.0	6.9	8.8	-1.1	-1.0	-0.6	-0.4	-0.4	-0.6
Other investment	5.3	-3.9	-6.7	-9.3	2.9	3.0	2.8	2.8	2.7	3.1
Derivatives (net)	0.2	-0.1	0.0	0.6	0.3	0.1	0.1	0.0	0.0	0.0
Reserve assets	0.2	0.2	1.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-0.3	0.4	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Gross external debt	124.1	139.5	137.4	129.0	126.5	125.5	124.7	123.6	122.4	121.4
Public sector	72.8	84.3	82.8	74.6	73.7	73.7	73.7	73.5	73.1	73.0
Private sector	51.3	55.2	54.6	54.4	52.7	51.8	51.0	50.2	49.3	48.5

Sources: National Authorities; and IMF staff estimates. BPM6 presentation.

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Table 4. Italy: Financial Soundness Indicators, 2017–22 1/

(Percent, unless otherwise noted)

	2017	2018	2019	2020	2021	2022
	Core FSIs for Deposit-taking institutions					
Regulatory capital to risk-weighted assets	16.7	16.1	17.2	19.3	18.8	19.2
Regulatory tier 1 capital to risk-weighted assets	14.3	13.9	14.9	16.9	16.5	16.7
Nonperforming loans net of provisions to capital	58.0	40.1	29.6	20.2	16.5	13.8
Nonperforming loans to total gross loans	14.4	8.4	6.7	4.4	3.3	2.8
Growth of bank loans to private non-MFI 2/	1.8	2.1	0.2	4.7	2.1	2.0
Nonfinancial corporations	0.2	1.4	-1.9	8.4	1.7	-0.4
Households	2.8	2.8	2.6	2.3	3.7	3.3
Return on assets	0.6	0.5	0.4	0.1	0.4	0.7
Return on equity	7.5	6.1	5.1	0.9	6.0	7.5
Interest margin to gross income	48.2	49.6	48.2	49.5	46.4	51.5
Net open position in foreign exchange to capital	1.3	0.7	0.4	0.8	0.0	4.0
Liquid assets to total assets	17.3	16.1	14.6	21.3	23.1	18.3
Liquid assets to short-term liabilities	83.9	76.1	74.8	97.7	96.9	86.7
Liquidity coverage ratio	…	…	…	…	…	188.1
Net stable funding ratio	…	…	…	…	…	132.4
	Encouraged FSIs for Deposit-taking institutions					
Capital to assets	6.6	6.3	6.7	6.6	6.1	5.9
Gross asset position in financial derivatives to capital	45.8	51.1	40.1	38.4	34.3	48.9
Gross liability position in financial derivatives to capital	43.2	55.7	43.2	40.2	36.1	48.9
Personnel expenses to noninterest expenses	54.3	52.1	53.2	54.2	53.1	52.0
Customer deposits to total (noninterbank) loans	69.1	67.9	75.1	68.5	90.6	78.1
Foreign-currency-denominated loans to total loans	8.6	8.1	7.8	6.3	7.1	6.9
Foreign-currency-denominated liabilities to total liabilities	7.3	7.5	7.3	6.0	6.0	…

Sources: IMF, Financial Soundness Indicators

1/ Data from the IMF Financial Soundness Indicators database have been updated, when possible, with Bank of Italy's or ECB's data.

2/ Data are from Bank of Italy.

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Table 5. Italy: Monetary Survey, 2017-22 1/

(Billions of euros)

	2017	2018	2019	2020	2021	2022
Net foreign assets	162	176	232	240	282	298
Claims on Nonresidents	279	298	324	337	388	411
Liabilities to Nonresidents	117	122	92	96	106	113
Net domestic assets	2991	2996	3050	3263	3350	3342
Claims on General Govt	955	1010	1058	1261	1359	1257
Claims on Other Sectors	2036	1986	1992	2002	1991	2085
Claims on Other Financial Corp	534	530	570	525	485	561
Claims on State & Local Gov	75	73	71	71	74	75
Claims on Private Sector	1427	1382	1351	1406	1432	1450
Broad money	1643	1684	1781	1970	2118	2098
Currency Issued	181	191	194	218	236	241
Demand deposits	1077	1132	1220	1373	1511	1488
Other Deposits	374	358	360	374	367	366
Secs Other than Shares	11	3	6	4	5	4

Sources: IMF, Monetary and Financial Statistics; and Bank of Italy.
Note: data is based on Euro Area residency reporting format.
1/ 2022Q3 data are latest available.

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Annex I. Risk Assessment Matrix

Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Global Risks			
Intensification of regional conflicts. Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems.	High	**High.** Negative energy, food and tourism shocks would impede the recovery. A severe output contraction would intensify sovereign-bank-corporate feedback channels, resulting in lower loan quality—including publicly-guaranteed loans—and raising funding costs for banks and the sovereign.	• Allow the existing means-tested citizenship income program and the short-time work scheme to provide an automatic income backstop for those facing job and income loss. • Provide additional temporary and targeted support to the most vulnerable households and viable firms alongside incentives for conservation if needed. • Continue efforts to diversify energy sources.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and markets fragmentation. In Europe, intensifying fallout from the war in Ukraine, worsening energy crisis and supply disruptions, and monetary tightening exacerbate economic downturns and housing market corrections.	Medium	**High.** Disruptions will adversely affect the profitability of firms by leading to market share loss, preventing firms from capitalizing on strong market demand due to unavailability of products, and increased costs. Funding will become more expensive. Disruptions can also negatively impact the productivity, utilization of assets, and tourism arrivals.	• Allow the existing means-tested citizenship income program and the short-time work scheme to provide an automatic income backstop for those facing job and income loss. • Promote high-quality public investment in infrastructure that facilitates global trade, such as ports, and information technology. • Advance structural reforms to maximize efficiency and competitiveness.
Social discontent. Supply shocks, high inflation, real wage drops, and spillovers from crises in other countries worsen inequality, trigger social unrest, and give rise to financing pressures and damaging populist policies. This exacerbates imbalances, slows growth, and triggers market repricing.	High	**Medium.** An inadequate policy response and weak global economy lead to higher unemployment and poverty.	• Extend targeted social spending and unemployment support according to need. • Facilitate structural reforms to boost future productivity and income growth.

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Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Commodity price volatility. A succession of supply disruptions (e.g., due to conflicts and export restrictions) and demand fluctuations (e.g., reflecting China reopening) causes recurrent commodity price volatility, external and fiscal pressures, and social and economic instability.	Medium	**High.** Could lead to second-round inflationary effects through wage contract negotiations; negatively impact business confidence, leading to lower investment and damage productivity growth. These effects can increase public discontent and loss in social cohesion, jeopardizing political stability.	• Provide well-targeted support to avoid excessive volatility in energy prices. • Promote investment in innovative energy systems.
Monetary policy miscalibration. Amid high economic uncertainty and volatility, major central banks slow monetary policy tightening or pivot to loosen monetary policy stance prematurely, de-anchoring inflation expectations and triggering a wage-price spiral in tight labor markets.	Medium	**Medium**. Pass-through from prices to wages has been limited, as collective agreements exclude import prices.	• Keep the public debt ratio on a firmly downward path through greater spending efficiency and a comprehensive tax reform to reduce domestic demand pressures and support the ECB in containing inflation. • Support vulnerable households.
Systemic financial instability. Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing markets dislocations and adverse cross-border spillovers.	Medium	**High.** Sharply higher sovereign borrowing costs and a shift in risk sentiment lead to bond repricing and financial tightening, a reduction of credit growth and further strains on leveraged corporates and households. Insolvencies increase, resulting in rapid deterioration of bank balance sheets and profitability. Tightening of financial conditions lead to housing market corrections. Sovereign spreads increase, raising concerns over fiscal sustainability.	• Ensure strong coordination between the ECB and the BdI on financial stability risks. • Rely on bank resolution systems to address unsound banks. • Implement a credible medium-term strategy to anchor public debt reduction. • Monitor the quality of publicly guaranteed loans. • Allow automatic stabilizers to operate and provide temporary support to vulnerable households.
Deepening geo-economic fragmentation. Broader and deeper conflict(s) and weakened international cooperation lead to a more rapid reconfiguration of trade and FDI, supply disruptions, technological and payments systems fragmentation, rising input costs, financial instability, a fracturing of international monetary and financial systems, and lower potential growth.	High	**Medium.** In the near term, escalating geopolitical tensions could undermine growth both directly and through adverse confidence effects and financial market volatility. In the medium term, deglobalization can give rise to reshoring and less trade, reducing potential growth.	• Continue support for the multilateral rules-based trading system, and advocate trade liberalization. • Ensure cooperation within EU and avoid retaliatory policies. • Safeguard energy security by accelerating the green transition.

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Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Cyberthreats. Cyberattacks on critical domestic and/or international physical or digital infrastructure (including digital currency and crypto ecosystems) trigger financial and economic instability.	Medium	**Medium:** Digitalization of the Italian economy is low but cyberattacks could still impair the functioning of the financial system and the economy.	• Raise awareness and enhance monitoring of cyberthreats. • Urge businesses/institutions to have robust cyber defenses and business continuity plan. • As per FSAP recommendations, increase the Bank of Italy's resources and activities on IT and cyber risk.
Extreme climate events. Extreme climate events cause more severe than expected damage to infrastructure (especially in smaller vulnerable economies) and loss of human lives and livelihoods, amplifying supply chain disruptions and inflationary pressures, causing water and food shortages, and reducing growth.	Medium	**Medium.** Climate-related losses could reduce real GDP and increase fiscal costs. EU members may receive migrants from economies facing severe climate disruptions.	• Leverage EU funds to make infrastructure more resilient to natural disasters. • Work with EU partners on region-wide response to migration.
Domestic Risks			
Inefficient or partial absorption of NextGenerationEU (NGEU) resources for investment in green and digital infrastructure, coupled with incomplete adoption of growth-enhancing structural reform to raise productivity.	Medium	**High.** High quality public investment together with comprehensive structural reforms in the NRRP would boost medium-term output and potential growth by enhancing the productive capacity of the economy.	• Promote high-quality public investment in digitization, green infrastructure, and education and innovation. • Adopt comprehensive structural reforms to raise productivity.
Ineffective tax reform which would result in a more regressive tax system that generates insufficient revenue.	High	**High.** Concerns about Italy's fiscal sustainability would jump, raising funding costs for the public and private sectors.	• Ensure reforms are guided by the principles of reducing complexity, broadening the tax base, and lowering marginal tax rates in a revenue-neutral way. • Reduce tax expenditures. • Continue improving tax compliance.

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Sources of Risk	Relative Likelihood	Impact If Realized	Policy Responses
Failure to put public debt firmly on a downward path. While public debt is projected to very gradually decline over the medium term, both the debt-to-GDP ratio and gross financing needs are expected to remain elevated and are therefore vulnerable to macro-financial shocks (e.g., a sudden shift in market sentiment, further tightening of financial conditions).	Medium	**High.** With already elevated public debt and gross financing needs, any macro-financial shock would increase Italy's already high borrowing costs, potentially triggering the need for a sharp fiscal adjustment. It could also lead to financing constraints for banks and a credit crunch.	• Implement a more ambitious fiscal adjustment starting in 2023. • Implement comprehensive fiscal and structural reforms to secure a stable source of revenues and lift potential growth.
Realization of financial sector vulnerabilities	Medium	**High.** Monetary tightening leads to deterioration in asset quality and valuation, and liquidity shortfalls. A shift in market perception undermines Italy's ability to roll over and service debt, and adversity affecting the banking system.	• Ensure strong coordination between the ECB and BdI on financial stability risks. • Rely on bank resolution systems to address unsound banks. • Allow automatic stabilizers to operate and provide temporary support to vulnerable households.

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Annex II. Sovereign Risk and Debt Sustainability Analysis

Table 1. Italy: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Moderate	Italy's overall risk of sovereign stress is assessed as moderate, but on the borderline. While public debt is projected to decline gradually subject to maintaining announced fiscal consolidation targets through the medium term, the debt ratio is expected to increase strongly over the long term on the back of rising pension spending and declining working age population.
Near term 1/			
Medium term	Moderate	Moderate	Medium-term risks are assessed to be moderate. This reflects sizable gross financing needs and increased reliance on private sector funding as the ECB continues to reduce its sovereign bond holdings. Scope to further increase holdings by the retail sector—typically buy-and-hold investors—would lengthen the effective maturity of debt. However, high uncertainty over assumptions (e.g., the interest rate-growth differential), and with the mechanical signal for the medium-term horizon close to the upper threshold, the assessment for the medium term is sensitive to small policy deviations, and which could also raise the overall risk assessment.
Fanchart	High	...	
GFN	Moderate	...	
Stress test	...	...	
Long term	...	High	Long-term risk is assessed as high. This reflects rising pension obligations under the legacy defined-benefit scheme and a shrinking working age population, which are expected to place the public debt ratio on a rapidly rising path within a decade.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	
Debt stabilization in the baseline			Yes

DSA summary assessment

Commentary: Italy's overall risk of sovereign stress is assessed as moderate, but on the borderline. Volatility reflecting high-frequency global and country specific developments constitutes a near-term risk, although this is mitigated by the relatively-long average maturity of government debt. Risk at the medium-term horizon is judged as moderate given sizable gross financing needs and increased reliance on private sector funding. Scope to further increase holdings by the retail sector—typically buy-and-hold investors—would lengthen the effective maturity of debt. However, high uncertainty over assumptions, and with the mechanical signal for the medium-term horizon close to the upper threshold, the assessment for the medium term is sensitive to small policy deviations, and which could also raise the overall risk assessment. Rising pension obligations under the legacy defined-benefit scheme and a shrinking working age population are expected to place the public debt ratio on a rapidly rising path within a decade. The risk of sovereign stress at the long horizon is therefore viewed as high.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

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Figure 1. Italy: Debt Coverage and Disclosures

1. Debt coverage in the DSA: 1/

CG	GG	NFPS	CPS	Other
	chosen			

1a. If central government, are non-central government entities insignificant? n.a.

2. Subsectors included in the chosen coverage in (1) above:

	Subsectors captured in the baseline	Inclusion	Comments
1	Budgetary central government	Yes	
2	Extra budgetary funds (EBFs)	No	Not applicable
3	Social security funds (SSFs)	Yes	
4	State governments	Yes	
5	Local governments	Yes	
6	Public nonfinancial corporations	No	
7	Central bank	No	
8	Other public financial corporations	No	

(CG: rows 1–3; GG: expected: rows 1–5; NFPS: rows 1–6; CPS: rows 1–8)

3. Instrument coverage:

Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/
chosen	chosen	chosen	missing	missing

4. Accounting principles:

Basis of recording		Valuation of debt stock		
Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/
	chosen	chosen		

5. Debt consolidation across sectors: Consolidated (chosen) | Non-consolidated

Color code: chosen coverage ■ Missing from recommended coverage ■ Not applicable

Reporting on intra-government debt holdings

Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1 Budget. central govt									0
2 Extra-budget. funds									0
3 Social security funds									0
4 State govt.									0
5 Local govt.									0
6 Nonfin pub. corp.									0
7 Central bank									0
8 Oth. pub. fin. corp									0
Total	0	0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: Italy's debt coverage and disclosure are consistent with standard recommendations and remain unchanged from recent Article IVs, while most debt is issued by the central government. Debt guaranteed by the government is not included in public debt.

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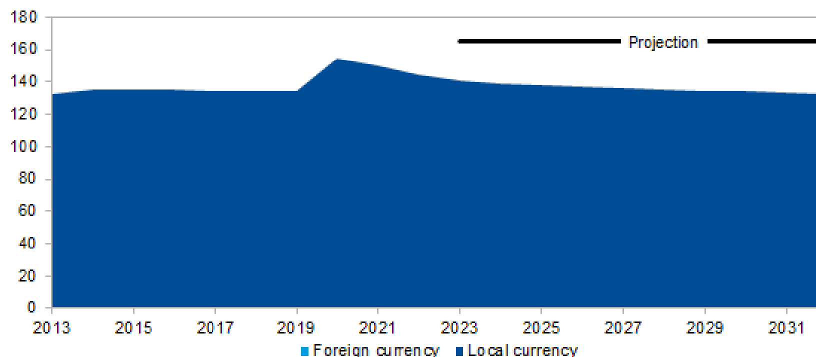
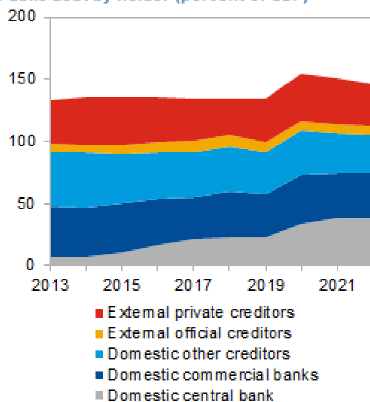
Figure 2. Italy: Public Debt Structure Indicators

Debt by currency (percent of GDP)



Note: The perimeter shown is general government.

Public debt by holder (percent of GDP)

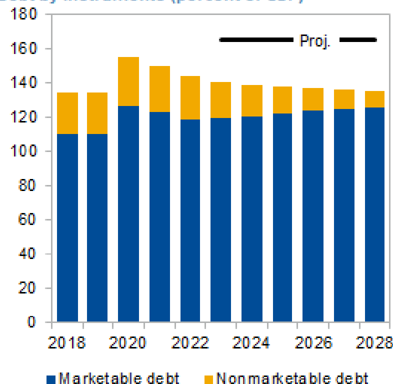


Note: The perimeter shown is general government.

Public debt by governing law, 2022 (percent)

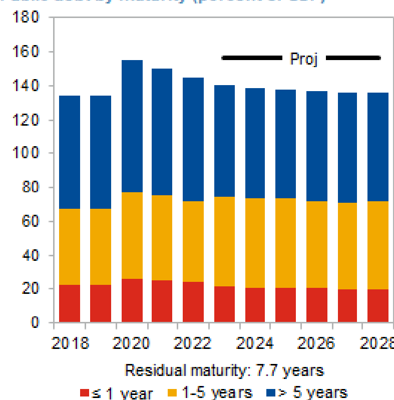
Note: The perimeter shown is general government.

Debt by instruments (percent of GDP)



Note: The perimeter shown is general government.

Public debt by maturity (percent of GDP)



Note: The perimeter shown is general government.

Commentary: Debt is predominantly in domestic currency and marketable.The majority of public debt is owned by residents with, one third of the debt held by the Bank of Italy. In recent months, new debt instruments targeting retail savers have been issued, and this is expected to continue. The average residual maturity of debt is 7.7 years.

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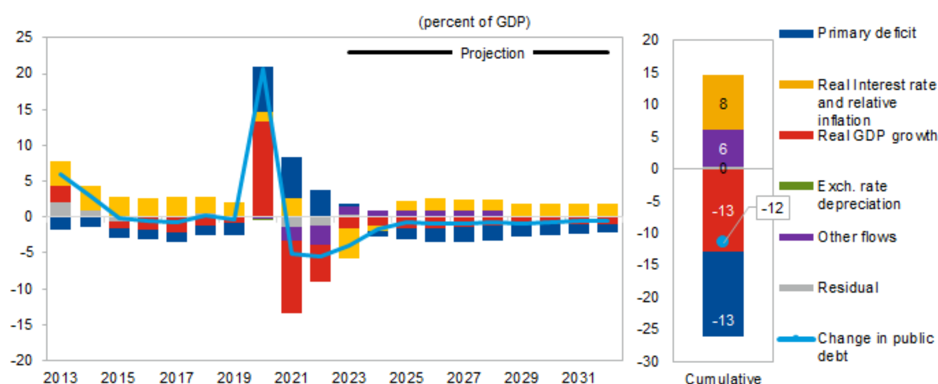
Figure 3. Italy: Baseline Scenario

(percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	144.4	140.5	138.8	138.1	137.2	136.3	135.6	134.6	133.9	133.3	132.9
Change in public debt	-5.4	-3.9	-1.7	-0.7	-0.9	-0.9	-0.7	-1.0	-0.8	-0.5	-0.4
Contribution of identified flows	-4.2	-4.2	-1.7	-0.7	-0.9	-0.9	-0.7	-1.0	-0.8	-0.6	-0.4
Primary deficit	3.6	0.5	-0.8	-1.4	-2.0	-2.0	-2.0	-1.7	-1.5	-1.3	-1.1
Noninterest revenues	48.8	48.8	47.4	47.2	46.9	46.6	46.3	46.3	46.2	46.1	46.1
Noninterest expenditures	52.3	49.3	46.6	45.8	44.9	44.6	44.3	44.6	44.7	44.8	44.9
Automatic debt dynamics	-5.2	-5.8	-1.9	-0.2	0.1	0.2	0.5	0.7	0.7	0.7	0.7
Real interest rate and relative inflation	0.1	-4.2	-0.7	1.3	1.6	1.7	1.7	1.8	1.8	1.8	1.8
Real interest rate	0.1	-4.2	-0.7	1.3	1.6	1.7	1.7	1.8	1.8	1.8	1.8
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-5.3	-1.6	-1.2	-1.6	-1.5	-1.4	-1.2	-1.1	-1.1	-1.1	-1.1
Real exchange rate	0.0	…	…	…	…	…	…	…	…	…	…
Other identified flows	-2.6	1.2	1.0	1.0	1.0	0.8	0.8	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	0.0
Other transactions 1/	-2.6	1.2	1.0	1.0	1.0	0.8	0.8	0.0	0.0	0.0	0.0
Contribution of residual	-1.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	28.6	24.6	24.2	23.2	22.5	22.4	22.0	22.5	22.8	23.1	23.2
of which: debt service	25.0	24.1	25.0	24.7	24.5	24.4	24.0	24.2	24.3	24.4	24.3
Local currency	25.0	24.1	24.9	24.6	24.5	24.4	23.9	24.1	24.2	24.3	24.3
Foreign currency	0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Memo:											
Real GDP growth (percent)	3.7	1.1	0.9	1.1	1.1	1.0	0.9	0.8	0.8	0.8	0.8
Inflation (GDP deflator; percent)	3.0	6.2	3.6	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Nominal GDP growth (percent)	6.8	7.4	4.5	3.3	3.1	3.1	2.9	2.8	2.8	2.8	2.8
Effective interest rate (percent)	3.1	3.0	3.1	3.2	3.2	3.3	3.3	3.3	3.3	3.4	3.4

Contribution to Change in Public Debt



Staff commentary: While public debt is projected to decline gradually subject to maintaining fiscal consolidation through the medium term, the debt burden is expected to remain elevated on the back of higher borrowing costs and low potential growth. After 2032 an influx of new retirees partly under the legacy defined-benefit pension system would cause the debt ratio to increase.

1/ These transactions include claims of tax credits that increase the borrowing requirement but whose effect on the primary balance was incurred in 2022 and earlier years.

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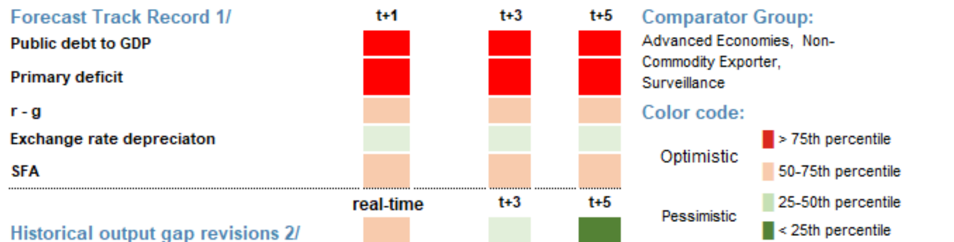
Figure 4. Italy: Realism of Baseline Assumptions

Forecast Track Record 1/



Comparator Group:
Advanced Economies, Non-Commodity Exporter, Surveillance

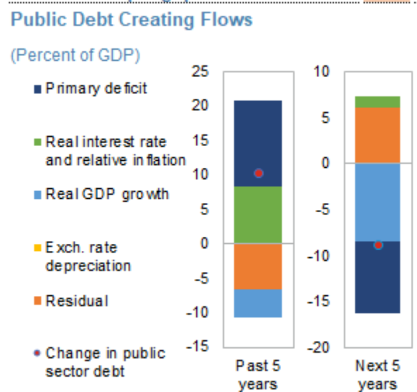
Color code:

Optimistic
> 75th percentile
50-75th percentile

Pessimistic
25-50th percentile
< 25th percentile

Public Debt Creating Flows

(Percent of GDP)

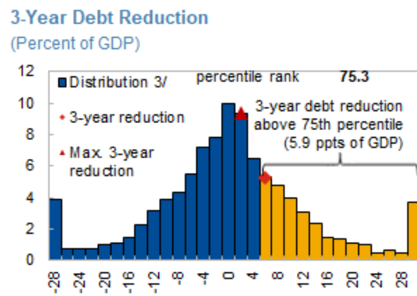


Bond Issuances (bars, debt issuances (RHS, %GDP); lines, avg marginal interest rates (LHS, percent))

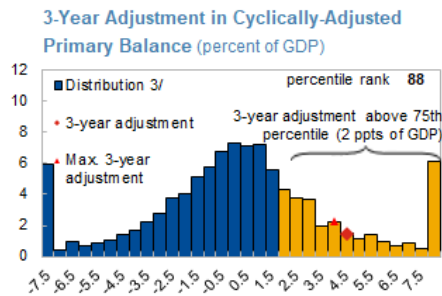
5+ yr term
1-5 yr term
<1 yr term
Spread vs 10-yr US Treas.
Implied spread, Laubach rule
5y hist
2023
2024
2025
2026
2027
2028

3-Year Debt Reduction

(Percent of GDP)

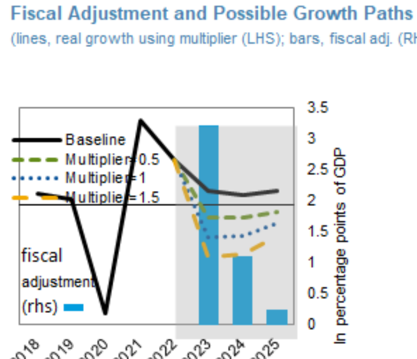


3-Year Adjustment in Cyclically-Adjusted Primary Balance (percent of GDP)



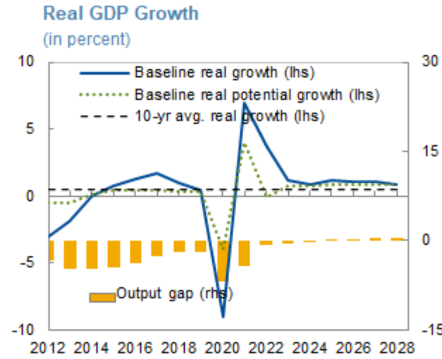
Fiscal Adjustment and Possible Growth Paths

(lines, real growth using multiplier (LHS); bars, fiscal adj. (RHS)



Real GDP Growth

(in percent)



Commentary: The recovery from COVID-19 and energy shock will impart complicated effects on the fiscal and debt path. The realism analysis shows a large median forecast error for medium-term primary deficit and debt projections over 2011-19, suggesting an optimistic bias, and a more moderate one for r-g projections. Consistently weak nominal GDP growth in the aftermath of the GFC and fiscal slippages kept the debt-to-GDP and primary deficit higher than staff's forecasts. However, since 2021 growth has been stronger than forecasted. The projected debt reduction is within norms; while the fiscal adjustment is above average, reflecting the unwinding of the large fiscal response to shocks in 2020-22.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

3/ Data cover annual obervations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

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Figure 5. Italy: Medium-Term Risk Analysis

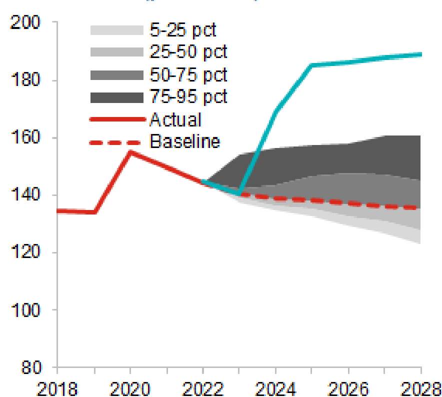
Debt Fanchart and GFN Financeability Indexes

(percent of GDP unless otherwise indicated)

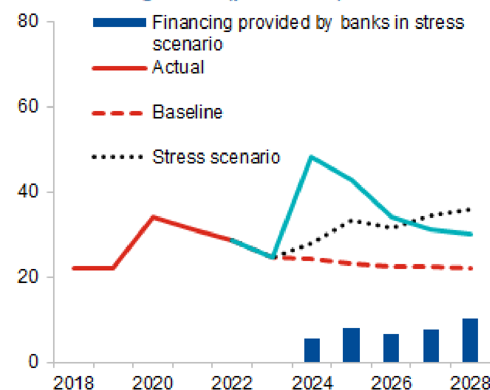
Module	Indicator	Value	Risk index	Risk signal	Adv. Econ., Non-Com. Exp
Debt fanchart module	Fanchart width	37.7	0.5	...	
	Probability of debt not stabilizing (pct)	19.2	0.2	...	
	Terminal debt level x institutions index	64.4	1.4	...	
	Debt fanchart index	**...**	**2.1**	**High**	
GFN finance-ability module	Average GFN in baseline	23.2	7.9	...	
	Bank claims on government (pct bank assets)	16.9	5.5	...	
	Chg. in claims on govt. in stress (pct bank assets)	7.3	2.4	...	
	GFN financeability index	**...**	**15.8**	**Moderate**	

Legend: Interquartile range; Italy

Final Fanchart (pct of GDP)



Gross Financing Needs (pct of GDP)

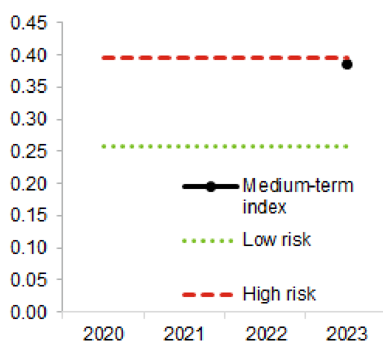


Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term Index

(index number)



Medium-term Risk Analysis

	Low risk threshold	High risk threshold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.5
GFN finaceability index	7.6	17.9	0.5	0.3
Medium-term index (MTI)	0.3	0.4	...	0.4, Moderate

Prob. of missed crisis, 2023-2028 (if stress not predicted): 27.3 pct

Prob. of false alarm, 2023-2028 (if stress predicted): 10.2 pct.

Commentary: Medium-term risk is assessed as moderate. The Debt Fanchart Module indicates high risk, reflecting in particular a high terminal level of debt. The GFN Financeability Module indicates moderate risk, given substantial average GFNs. A banking crisis shock, triggered manually, could result in a substantial increase in public debt. Medium-term risks are mitigated by the potential to increase government bonds holdings by retail investors, who tend to provide stability as mainly buy-to-hold investors, and—by replacing some shorter-term debt—would lengthen the average maturity of debt. However, high uncertainty over assumptions (e.g., the interest rate-growth differential), and with the mechanical signal for the medium-term horizon close to the upper threshold, the assessment for the medium term is sensitive to small policy deviations, and which could also raise the overall risk assessment.

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Annex III. External Sector Assessment

Overall Assessment: *The external position in 2022 was weaker than the level implied by medium-term fundamentals and desirable policies.* The degree of uncertainty for the 2022 CA gap assessment is heightened by the lack of clarity about the perceived persistence of the very large negative energy terms of trade shock. The current account balance declined, in large part due to a temporary increase in the gas import bill, that resulted in a decline in private sector saving net of investment while government saving net of investment remained broadly unchanged. Tax credits for the superbonus program promoted household investment, and while the government provided large energy-related transfers, households' saving net of investment dropped by about 4 percentage points of GDP as the saving rate normalized from its COVID-19-era high. While investment increased moderately in 2022, chronic weak productivity, rapid population aging, and uncertain medium-term growth prospects could dampen investment once tax credits and other fiscal programs under the National Recovery and Resilience Plan are completed.

Potential Policy Responses: Raising productivity and improving the business climate through structural reforms would encourage higher private investment and normalization of the household saving rate while implementing high-quality fiscal consolidation measures would ensure the fiscal primary balance returns firmly to surplus. In particular, upskilling the workforce and increasing the quality of infrastructure and the effectiveness of the judiciary and public administration would boost productivity to help counteract workforce aging. Vulnerabilities associated with rollover of public debt would be reduced by improving budget efficiency, containing pension spending, undertaking comprehensive and progressive tax reform, and fully implementing the National Recovery and Resilience Plan.

Foreign Asset and Liability Position and Trajectory

Background. Italy's NIIP declined to 3.9 percent of GDP at the end of 2022 on account of net valuation losses (3.2 percent of GDP) and the first CA deficit in a decade. Gross foreign assets and liabilities retreated to 174.3 and 170.5 percent of GDP, respectively, as losses on external equity positions outweighed dollar appreciation. Nevertheless, TARGET2 liabilities reached a record high of 36 percent of GDP. About half of gross external liabilities correspond to the general government and the Bank of Italy. Over the last decade, Italy has seen continuous financial outflows by the resident private sector to acquire foreign assets, while the Bank of Italy has become the main contributor to financial inflows. Steady accumulation of direct and portfolio investments in foreign equities and a net long dollar external position have contributed to the net valuation gains on Italy's NIIP during this period.

Assessment. Further strengthening public balance sheets and undertaking structural reforms would lessen vulnerabilities associated with the high public debt, reinvigorate economic growth, and reduce the potential for negative feedback loops between the debt stock and debt-servicing costs.

2022 (% GDP)	NIIP: 3.9	Gross Assets: 174.3	Debt Assets: 41.3	Gross Liab.: 170.5	Debt Liab.: 92.2

Current Account

Background. Italy's CA has experienced gradual increases, averaging 3.0 percent of GDP during 2016–21. This increase was underpinned by rising private sector gross national saving and lower public and private sector gross domestic investment. More than half of the increase in the CA balance is due to the trade surplus, with the rest reflecting strong dividend and interest income on the rising foreign asset holdings of the nonfinancial private sector as well as declining interest payments on external liabilities owing to the ECB's accommodative monetary stance. In 2022, the CA dropped sharply, by 4.3 percentage points, to -1.2 percent of GDP, mainly on account of a 3.3 percent of GDP increase in the energy trade deficit as the terms of trade worsened by 8.5 percent, despite a continued recovery in exports of goods and services (on par with 2019 levels in real terms). The CA reduction was underpinned by a moderate increase in investment and a large decrease in total saving, with declines in private saving mostly in the household sector and roughly unchanged government saving. The effects of commodity price shocks on the current account began to unwind in late 2022. The medium-term CA balance is likely to be lower than the pre-pandemic position due to permanently higher energy price levels.

Assessment. The cyclically adjusted CA is estimated at 0.6 percent of GDP for 2022, 2.9 percentage points below the EBA-estimated CA norm of 3.4 percent of GDP. An Italy-specific COVID-19 adjustor of 0.4 percent of GDP is applied to account for a temporary decline in travel (0.1 percent) and transport (0.3 percent) net receipts caused by the pandemic. Therefore, and taking into account uncertainty around the estimate, the IMF staff assesses the CA gap to be in the range of –3.2 to –1.8 percent of GDP, with a midpoint of –2.5 percent of GDP. The fiscal policy gap (–1.5 percent of GDP) contributed substantially to the total policy gap (–1.0 percent of GDP), reflecting the sizable fiscal deficit in 2022.

2022 (% GDP)	CA: –1.2	Cycl. Adj. CA: 0.6	EBA Norm: 3.4	EBA Gap: –2.9	COVID-19 Adj.: 0.4	Other Adj.: 0.0	Staff Gap: –2.5

Real Exchange Rate

Background. During 2016–21, the CPI-based REER depreciated by 0.4 percent, while the ULC-based REER depreciated by 1.8 percent. During 2022, the CPI-based REER further depreciated by 2 percent relative to the 2021 average, as a weakening euro more than compensated for Italy's relatively higher inflation than its trading partners. As of April 2023, the CPI-based REER appreciated by 2.8 percent relative to the 2022 average as the euro strengthened against a basket of currencies while energy inflation started to decline.

Assessment. The IMF staff CA gap implies a REER gap of 9.3 percent in 2022 (with an estimated elasticity of 0.27 applied). The level and index CPI-based REER models suggest an overvaluation in 2022 of 15.4 percent and 12.3 percent, respectively, with an average of 13.9 percent. Based on the IMF staff CA gap, the staff assesses a REER gap to be in the range of 6.5 to 12.0 percent, with a midpoint of 9.3 percent.

Capital and Financial Accounts: Flows and Policy Measures

Background. The capital account balance remained unchanged at 0.0 percent of GDP in 2022. The financial account posted net inflows of 0.8 percent of GDP in 2022, reflecting residents' net acquisition of foreign liabilities. Large portfolio investment outflows were more than offset by inflows of other investment, including a nearly €60 billion increase in Italy's TARGET2 liabilities.

Assessment. Central banks' monetary policy tightening has pushed up yields in the sovereign debt market. Large refinancing needs of the sovereign and the banking sector, elevated inflation, and exposures to geopolitical tensions and energy shocks suggest Italy remains vulnerable to market volatility.

FX Intervention and Reserves Level

Background. The euro has the status of a global reserve currency. Italy's reserves remained largely unchanged in 2022.

Assessment. Reserves held by the euro area are typically low relative to standard metrics, but the currency is freely floating.

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Annex IV. Progress on Past IMF Recommendations

2022 Article IV Policy Advice	Actions Since 2022 Article IV
I. Fiscal Policy	
Fiscal Adjustment	
Very high public debt and rising borrowing costs call for accelerating potential growth and steadily—but decisively—raising the primary balance, underpinned by structural reforms and rationalizing spending. Carve out room for public investment by growing primary current spending, including tax expenditure, consistently below nominal GDP growth.	The April 2023 Document on Economy and Finance envisages a gradual path of fiscal consolidation toward achieving a 2 percent primary surplus in 2026. No underlying structural measures have been identified to support adjustment
Improve the Quality of Fiscal Policy	
Improve the design of the citizenship income program and adapt it to the cost of living in various parts of the country.	The citizenship income program is being phased out and is being replaced by a dual program: family assistance for low-income families with children and those unable to work, and worker training and temporary benefits for those able to work.
Improve capital spending, the quality of projects, and fully implement the NRRP.	Capital spending will be raised significantly during 2023–26 under the NRRP and to alleviate bottlenecks, a new procurement code seeks to enhance competition and transparency, including through centralized purchasing.
Lower the subsidy rate on Superbonus tax credits, improve controls on approvals and phase out the scheme.	The authorities lowered the subsidy rate in 2023 from 110 percent to 90 percent, and a further reduction to 65 percent is expected in 2024. In addition, tax credits are no longer transferable, reducing the attractiveness of the scheme.
Undertake a comprehensive tax reform to broaden the tax base, lower statutory tax rates, and help fight evasion while preserving progressivity and revenue neutrality.	The government introduced a proposal for a comprehensive reform of the tax system, which is now being prepared. The proposals aim to lower the tax burden and strengthen the economy's supply side by encouraging investment, innovation, and employment.
II. Energy Policy	
Compensation for high energy bills should be temporary, target vulnerable households and viable firms, and high wholesale prices should be passed through to end users to encourage conservation.	The energy compensation measures are being phased out given the moderating energy prices. Measures have become more targeted, and with larger passthrough to end-user prices. However there is room to improve targeting of remaining measures.
To accelerate the green transition, energy taxes should be based on their carbon content and equated across energy sources, while incentives for green investments should be made more cost effective.	The superbonus scheme on energy-efficiency of buildings will expire at end-2025, and subsidy rates will continue to decline in the interim. New guarantees may be used to support investment needs, including those related to the green transition. Energy efficiency mandates, including minimum cooling and maximum

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	heating settings, have been successful in encouraging conservation.
III. Financial Stability	
Maintain Bank Lending and Liquidity Support to the Real Economy	
Any new guaranteed loan scheme should be selective, and banks should retain a sizable share of the credit risk. Guarantee coverage rates should be reduced.	The COVID-era public guarantee schemes were phased out; legislative loan moratoria for firms expired. A new targeted public guarantee scheme for energy was introduced but its use has been limited so far.
Enhance Banks' Asset Quality, Credit Risk Management, and Business Models	
Banks should prepare for severe downside scenarios and temporary capital conservation may be required in specific instances.	The authorities are monitoring banks' capital and liquidity plans. Recent harmonization of the framework for covered bonds with EU standards provides banks an additional source of long-term funding.
Address Distressed Banks	
Continue identifying weak banks alongside further consolidation of the sector.	Assessments of banks' business models have identified a limited number of smaller banks with serious weaknesses. Where needed, early intervention measures and orderly exists from the market were adopted. Consolidation slowed down.
IV. Structural Reforms[1]	
Public Administration	
Streamline debt resolution procedures to reduce debt overhangs, release trapped capital and attract new investment. Modernize public administration to efficiently executing public investment and reinforce Italy's governance framework to strengthen the financial integrity of NRRP resources.	Legislation and implementation frameworks to support the execution of public administration reforms under the NRRP were adopted. Progress has been made with reforms to modernize public administration. To accelerate NRRP implementation, oversight of the Plan has been shifted from the Ministry of Finance to the Prime Minister's office.
Insolvency and Judicial Reforms	
Integrate the newly introduced out-of-court restructuring procedure into the new Insolvency Code. Additional court resources should help timely resolution of cases. Relax the design of the early warning mechanisms by removing mandatory insolvency triggers.	Provisions of the new Insolvency Code, including an out-of-court mechanism of negotiated restructuring, are available for creditors and debtors. The revised provisions of the Insolvency Code amended the early warning mechanism, providing for its voluntary use and removing the mandatory nature of the distress triggers.
Monitor the effectiveness of the new legal framework for insolvency and debt enforcement, as well as progress with reducing the backlog of court cases.	The authorities are monitoring the effectiveness of the new legal frameworks for insolvency and debt enforcement. As part of the NRRP, progress has been made with reforms to modernize judiciary and simplify civil procedures.
Labor Markets	
Avoid welfare dependence and disincentives to work, by offering job suitable openings and training	The citizenship income program has been split into two parts; for those able to work, a benefit for up to 8 months is available, conditional on participating in

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opportunities, and withdrawing benefits gradually in as earned income rises.	training, while benefits are discontinued if a job offer is refused. Those unable to work or with dependent children are eligible for permanent benefits on a means-tested basis. NRRP reforms seek to address some of the labor market's structural challenges through vocational training, adult learning, and strengthening of work-based training.
Product Markets/Competition	
Strengthen competition to improve the business environment, efficiently execute public investment, as well as building growth-enhancing infrastructure and institutions.	In the NRRP, the authorities have committed to streamline product market regulation and review the Competition Law annually.

[1] See https://italiadomani.gov.it/en/Interventi/milestone-e-target.html for more details on milestones and targets of the NRRP to be achieved by 2026.

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Annex V. Implementation of Key 2020 FSAP Recommendations

Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
Enhance banks' capital levels, as appropriate, to ensure all banks maintain adequate capital ratios under stress scenarios.	In 2022 Pillar 2 Guidance (P2G) continued to increase, such that, over the period 2020-2022 the P2G more than doubled, reflecting a strengthening of the capital amount of the banks to cover stress scenarios. Anyway the review of the P2G remains an on-going activity.	Following recent developments at the regulatory and supervisory levels, Bank of Italy (BdI) introduced a new approach for the determination of the P2G for LSI banks that represents the main tool for ensuring adequate capital ratios based on a stressed scenario analysis. Such approach, which allocates banks into different buckets of P2G, envisages a strong correlation between the results of the stress test (i.e., supervisory stress test complemented by internal stress test stemming from ICAAP) and the P2G capital demand. It is compliant with the new regulatory package CRR/CRD as well as the EBA Guidelines on SREP and implements the methodology defined at SSM level. The combined effect produced by this new approach and the severity/features of the stress test methodology determined a significant increase of the average P2G for LSI banks that have received a new capital decision in 2021. The same approach will be applied in the SREP of 2022. Moreover, in line with the decision made by other Competent Authorities and in line with the policy stance adopted at the international level, the authorities' requested a prudent approach for dividend distributions from 2019 to 2021, as a response to the challenges posed by the COVID pandemic. This approach determined a strengthening of banks' capital ratios.	Bank of Italy (BdI), SSM	ST
Consider more timely escalation of corrective measures for weak banks to effect improvement (e.g., in capital levels, operational efficiency,	The horizontal analyzes carried out after the outbreak of the pandemic have been updated to maintain a clear view on the prioritization of banks based on ri	the central credit register and, for a sample of LSIs, on the analysis of the main positions benefiting from a moratorium. This approach led to the determination of an "adjusted NPL" stock, to which BdI applied the benchmark coverage ratios used in	BdI	I

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
governance) or achieve consolidation or orderly wind-downs when needed.	With reference to the limited number of LSIs with serious weaknesses, in one case an early intervention measure has been adopted, while in the other cases the situation was solved or concrete turnaround projects have been started. Furthermore, as part of a broader rearrangement in Banking Supervision 2 Directorate, in 2022, a dedicated "Sector" has been created to better focus the supervisory activity on weak banks and on those involved in turn-around initiatives.	the BdI stress test. Finally, the estimated potential under-provisioning was translated into capital impacts. The third part of the analysis concerned the estimation of the restructuring costs that banks would have to incur (in terms of the reduction in extra staff) in order to achieve efficiency levels equal to those of the most virtuous banks. The findings of each strand of analysis were subsequently aggregated, by virtue of a holistic approach, to identify those banks that could suffer most from the effect of the higher risks in 2022 as a way to better target the supervisory intervention strategies. In this context, the riskiest banks were clustered according to the severity of the potential impacts. A limited number of small banks were identified as characterized by serious weaknesses. For these banks, specific turnaround projects with the involvement of third-party investors are currently under assessment. Were these projects to fail, a further escalation of the supervisory action may become necessary, including early intervention measures. In the case of a crisis, initiatives consistent with the crisis management policy adopted (see below "Reinforcing crisis management and safety nets") will be taken. Where the conditions are met, support by the Italian DGS or of the public scheme for the liquidation of small banks could help in minimizing negative effects on depositors and on the local economy. For a few banks included in a second cluster that still have margins to autonomously carry out turnaround processes, supervisory interventions will focus on initiatives aimed at increasing business model		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		sustainability and reducing legacy assets. If deemed necessary, reaching specific targets related to operating efficiency (i.e., cost-income ratio target) or credit quality (i.e., NPL reduction target) could be asked within specific action plans. Up to now, the management of problem in small weak Italian banks has been effective, following the objective of minimizing negative effects on depositors and on the local economy. Nonetheless, it is important to underline, as already represented to the IMF in previous discussions, the shortcomings of the EU crisis management framework and the constraints that it imposes on national authorities, particularly in countries with a large number of LSIs (see "Reinforcing crisis management and safety nets" below). The BdI has promoted a debate in the EU on the lack of a suitable framework for dealing with the crises of small and medium sized banks that is now at the center of the review of the Crisis Management and Deposit Insurance (CMDI) framework. More details on this issue are provided in: (https://www.bancaditalia.it/pubblicazioni/note-stabilita/2019-0015/Note-stabilita-finanziaria-n15.pdf) In addition, starting from 2018 the BdI has implemented an Early Intervention framework supported by an IT tool aimed at automatically detecting potential financial deteriorations of LSIs under its jurisdiction. The tool is back-tested periodically and the relevant thresholds for the alarms annually calibrated; in the aftermath of the pandemic, the thresholds have been adjusted in order to further reduce the risk tolerance of the framework. The framework has been recently		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		refined in order to provide a more holistic picture of the potential weaknesses of the LSI under scrutiny (inter alia, credit risk and business model sustainability). In order to improve banks' governance arrangements and to enhance the timely implementation of corrective measures (including early intervention measures), in February 2022 the BdI achieved compliance with the new EBA guidelines on recovery indicators (EBA GL 2021/11) with the issuance of new provisions on recovery plans. These provisions offer additional guidance to institutions on the general principles to be followed in setting the thresholds of recovery plan indicators in order to: i) shorten the time for the bank's autonomous decision to activate their recovery plan; ii) ensure the timely notification of recovery plan indicator breaches to the competent authority; iii) engage in a more frequent monitoring of indicators in a situation of crisis for the institution and the competent authority.		
Perform more periodic deep dives and thematic and targeted inspections on key LSI weaknesses such as bank governance, credit risk, and business models.	At the end of 2022, given the changes in the business environment driven by the effects of the war and the changes in the ECB monetary policy the BdI requested LSIs to provide comprehensive updated information with regard to their strategic and funding plans over a two years' time-horizon in order to assess the main drivers of business model and profitability as well as funding solutions foreseen by LSIs in the view of the LTRO reimbursement.	In the last two years, the BdI performed deep dives and thematic analyses on both off-site and on-site level. With regard to off-site analyses, an "inspection-oriented" approach was followed in several cases. In particular, the BdI has been increasingly intrusive on governance issues. In this regard, a thematic review on the governance systems of LSI's was recently concluded, focusing on the composition (in terms of size, expertise and formal independence) and functioning) of the Management Board in its supervisory functions (MBSF) (e.g., committee structure,	BdI	ST

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
	With reference to the on-site activities, the BdI has continued to carry out on-site inspections on LSIs, driven by risk exposure, size and complexity as identified via SREP. The inspections conducted were focused mainly on credit risk, internal control, risk management, business model and profitability. For LSIs, full-scope inspections continue to be the most suitable approach to investigate local banks. However, BdI is regularly assessing the need for deep dives and targeted and thematic inspections; for instance, given the new stressed financial conditions, in 2023, five inspections are planned: four thematic inspections on liquidity risks and, for an idiosyncratic situation, one inspection targeted on internal governance. Furthermore, from 2020 on, BdI has further calibrated the planning selection criteria for on-site inspection in order to better focus even more on the riskiness profile of the supervised institution at country level.	reporting, role of the MBSF chairman, level of discussion within the Board). The assessment was performed through an innovative methodology that leveraged both off-site and on-site tools and approaches, guided by the analysis of information and documents requested from a sample of LSIs (e.g., selected minutes of board meetings and accompanying documentation), as well as direct interviews with board members (chair, executive and nonexecutive members). Upon completion of the interviews, a benchmarking analysis has been carried out to identify good and worst practices and make recommendations to the LSIs. The task force shared the results of the analysis with the structures in charge of off-site supervision, which could take appropriate action against individual LSIs where necessary. With reference to credit risk, particular attention was reserved to the ways banks have supported households and firms by providing government measures introduced in response of the outbreak of the pandemic (i.e. credit moratoria). In this context, a sample of LSIs was subject to a specific in-depth assessment regarding the main exposures interested by moratoria, in order to investigate the risk of potential cliff effects related to the phase out of the public measures. The analysis was embedded in the scope of a wider horizontal exercise aimed at assessing the sustainability of the LSIs' business model in relation to the potential impacts of the pandemic. In this regard, in 2020 the BdI requested a sample of LSIs—mainly "traditional banks"—to carry out a comprehensive business model self-assessment in a time horizon of two years, representing possible vulnerabilities and planned remedial		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		actions. In 2021, the BdI reviewed the feedbacks and followed-up by requesting the banks to provide further information and by launching a supervisory dialogue on the matter. The results of the analysis helped to categorize banks into different business model risk profiles which, in conjunction with further drill down on the banks' loan portfolio quality and the investments needed to raise profitability, supported a better focus of the intervention strategies on the weakest banks (see above). With reference to the on-site activities, the BdI has continued to carry out on-site inspections on LSI, driven by risk exposure, size and complexity identified via SREP. In 2020 and part of 2021, on-site inspections were significantly impacted by the pandemic restrictions, although a hybrid approach (mixing on-site presence at the banks' premises and remote analyses) was adopted. Against this background, the missions performed were focused mainly on credit risk, internal control and risk management, as well as business model and profitability. For smaller banks, full-scope inspections continue to be the most suitable approach to investigate local banks. On larger LSIs, targeted missions were carried out more frequently—with an increase in the number of targeted and thematic missions. Those investigations have been recognized as more suitable to investigate banks with higher complexity and diversified business and organization. In this regard, targeted missions were performed both in 2019 and 2020 with a focus on business model and profitability, internal governance and risk management. Moreover, in 2020 a thematic review was carried out for the first time on		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		two IT outsourcer providers, with the aim of assessing governance and control of IT services support to the client banks. In 2021, an on-site thematic campaign was launched in order to assess the adequacy of the procedures, governance, risk management and AML control of the Government support pandemic finance.		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
Continue scrutinizing banks' credit risk and loan classification and provisioning practices, particularly of UTP portfolios, and challenging progress and ambition of banks' NPL reduction plans.	The BdI continued to scrutinize banks' loan classification and provisioning practices and to monitor and challenge their NPL management strategies, both through regular horizontal analyses (e.g. NPL plans analysis) and through bank specific insights (off site or on site). During the on site activity, the banks' credit risk practices continue to be the main area of assessments both in full scope and targeted inspection. Furthermore, it was conducted a thematic campaign on servicer and investment firms to assess their capacity to manage the NPL securitized portfolios, largely originated by the bank's for reducing the NPL ratio. Also the OSI methodology was improved during 2022 to better reflect the best practices in the IFRS9 area and in the services of securitization.	The BdI has continued its action of scrutiny of loan classification and provisioning practices in the regular context of the supervisory review and evaluation cycle and through the on-site activities. The NPL reduction plans (submitted annually by a subset of directly supervised less significant banks) are subject to both horizontal and individual analyses aimed at assessing the results concretely achieved in the NPL management related activities, the expected evolution of the NPL portfolio and the actions (contents and ambition) identified by the banks within the NPL strategies. A horizontal analysis has been also performed with reference to the management of the unlikely to pay exposures. It allowed us to figure out a set of best practices which were also disclosed on the BdI Website (https://www.bancaditalia.it/media/notizia/note-di-stabilit-finanziaria-e-vigilanza-n-28-indagine-sulla-gestione-delle-inadempienze-probabili/?dotcache=refresh). Given the current and expected development of the credit securitization market, the BdI also intensified its supervisory action towards supervised entities active in servicing activities in credit securitization transactions, with a cycle of supervisory meetings and the planning of on-site inspections. In this context, last November the BdI sent a communication to the banking and financial servicers that aimed to highlight the sector's risks and formulate recommendations on the appropriate controls to be adopted in the servicing business.	BdI, SSM	C

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		In addition, steps were taken to collect more information. At the same time, analyses were conducted to investigate the operations of funds investing in loans, given the growing interest of asset managers in these asset categories. In this context, interviews were carried out with some of the most active managers in this market segment, also through a specific questionnaire, and a cycle of targeted inspections was launched. As a result of these initiatives, it will be possible to improve the supervision methodologies on the servicers, on the specialized asset management companies and on the funds managed and give policy indications to the industry.		
Consider extending the SSM approach that sets bank-specific expectations for the gradual path to full provisioning on existing NPL stocks to LSIs with high NPLs with an adequate phase-in period; and update the LSIs' NPL management guidance.		Regarding the NPL management guidance, the full compliance with the EBA Guidelines (GL) on NPE management (EBA/GL/2018/06) has been recently attained, by replacing the previous national GL issued in 2018. Thanks to the high similarity between the two GLs in terms of additional obligations for high NPLs LSIs, achieving full compliance with the EBA GL has only slightly increased the number of banks subject to a stricter monitoring on the NPE management strategy. (https://www.bancaditalia.it/compiti/vigilanza/normativa/orientamenti-vigilanza/elenco-esa/note/Nota-n-26-del-5-aprile-2022.pdf). Considering the whole population of LSIs and regardless of the level of the NPL ratio, the assessment of coverage adequacy and the increase of provision levels, both for performing and non-performing exposures, have	BdI	I

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		always represented a priority for the national banking supervisor. In particular, the current SREP methodology defines a specific supervisory proxy to calculate a P2R and a P2G add-on to cover the risk of under-provisioning, respectively in normal and stressed conditions (taking into account the severity and the vintage of the non-performing status, the IFRS staging for the performing portfolio and the status of secured/unsecured). In this context, the updated methodology for the calculation of P2G and P2R capital requirements (for additional details on the new methodology and related impacts see answer provided for recommendation 1) and the subsequent supervisory action, allowed us to reach significant results, in terms of both coverage levels and the workout of NPL legacies (see also answer provided for recommendation number 4), even though the ECB calendar approach has not been extended to the existing NPL stock in the LSIs' portfolio.		
Amend relevant laws to confer BdI and IVASS authority on removal of authorization and winding-up of banks and insurers, respectively.		The Ministry's involvement in the decision-making process for the initiation of resolution or liquidation does not affect the BdI's operational independence and timely intervention, since: • the initiation by the Ministry may occur only based on a BdI proposal; • does not affect the BdI's operational independence: while the Minister might either refuse or accept the BdI's proposal, as a matter of fact, it may only accept it, as a refusal would inevitably further exacerbate the bank's	MEF, MISE	ST

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
		conditions, leading eventually to the commencement of resolution/liquidation; • the Minister's involvement provides the BdI a shield from social/political pressures and establishes a form of responsibility-sharing that is very effective in ensuring that a resolution/liquidation decision is effective and timely taken; • is necessary in light of the potential impacts of these decisions on creditors' property rights and on the financial, economic and social context potentially affected by these decisions. As for the insurance sector, the matter falls within the competence of the Italian Parliament. As far as BdI knows, there are no legislative initiatives in progress, aimed at modifying the current legislative framework. According to the current legislative framework (Art. 240 of the Italian Insurance Code—Withdrawal of the authorization issued to an insurance undertaking) the insurance undertaking authorization shall be withdrawn by decree of the Minister of Economic Development, upon IVASS' proposal. If the authorization is withdrawn for all the insurance classes pursued, the undertaking immediately goes into compulsory winding up.		
Address gaps in governance regulations of banks and insurance companies by issuing the draft MEF and MISE decrees.	In addition to the Regulation setting up F&P requirements for corporate officers Ministerial Decree 169/2020), the competent units, together with the BdI, have drafted the new regulation aimed at	With regards to banks, the decree setting the suitability requirements for banks' board members and key function holders entered into force on January 30, 2020 (i.e., ministerial decree no. 169/2020) and is in line	MEF, MISE	I

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Bank Supervision and Regulation and NPL Resolution				
	reviewing the decree on the suitability of major shareholders. The text is currently under evaluation by the Government.	with the relevant framework provided by the CRD and the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders. The suitability assessment procedure is provided in the Consolidated Law on Banking as complemented by an ad hoc Regulation of the Banca d' Italia adopted on May 4, 2021. With regard to the insurance sector, Ivass has provided its technical contribution to MISE for defining the regulation concerning the fit and proper requirements applicable to corporate officers and persons who carry out key functions, implementing art. 76 of the Italian Insurance Code. Ivass has also proposed to MISE to set up with a coordinated table with MEF in order to draft the regulation applicable to qualifying shareholders in insurance companies, implementing art. 77 of the Italian Insurance Code. Such proposal is aimed at providing a coordinated regulation for the financial sector, considering also the ESA's Joint Guidelines issued in the European context and the need to ensure a level playing field.		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Macroprudential Policies and Framework				
Establish a national macroprudential policy authority with a leading role for BdI.	The legislative proposal (schema di decreto legislativo) aimed at establishing the national macroprudential authority, drafted according to Law 127/2022 (Art. 6) in cooperation with the Competent Authorities involved, is currently under evaluation by the Government.	The Italian government is planning to promote a legislative initiative establishing the national macroprudential policy authority in the form of a Committee with a leading role for BdI. The legislative proposal is included in the "DDL Delegazione Europea" (DDL 2481) and it is currently under evaluation of the relevant Parliament Commissions.	MEF, IVASS, BdI, CONSOB	ST
Incorporate the Systemic Risk Buffer (SyRB) and borrower-based tools into the macroprudential toolkit.		February 2022 the Systemic Risk Buffer and borrower-based measures have been incorporated into the BdI's macroprudential toolkit via a revision of the Circular n. 285. (https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/aggiornamenti/Atto-emanazione-38agg.pdf)	MEF, BdI	ST
Consider implementing prudential policies to moderate the sovereign-bank nexus with an appropriate phase-in period to avoid possible market disruptions.		No actions are planned beyond regular/continued monitoring. In any case, our view is that in the euro area/EU any such action at the national level is not advisable. As it is known, political discussions at the EU level on completing the banking union continue.	BdI	MT
Recommendations	**Implementation Status[1] - 2023**	**Implementation Status[1] - 2022**	**Agency**	**Time[2]**

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Insolvency Framework				
Enhance the enforcement and insolvency framework and ensure that courts have sufficient resources and specialization to timely handle insolvency cases.	The new Insolvency Code relaxed the early warning mechanism providing for its voluntary use and removing the mandatory nature of the distress triggers. The Code also provides for a wide range of restructuring tools available for creditors and debtors, including the most recent out-of-court mechanism of negotiated restructuring i.e., "composizione negoziata".	In August 2021, decree law 118/2021 introduced a novel framework to enhance out-of-court workouts (negotiated workout for resolving a firm's crisis). In July 2022, the novel bankruptcy code (legislative decree 14/2019) will enter into force, as amended in order to implement the EU preventative restructuring directive. Since January 2022, art. 35-ter of the law 233/2021 provides that judges dealing with bankruptcy proceedings shall undertake professional courses in order to enhance technical specialization, particularly in smaller courts. The new code strengthens bankruptcy professionals appointment and training requirements.	MoJ, NJC	ST

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Reinforcing Crisis Management and Safety Nets				
Establish additional loss absorbing capacity to enable greater loss allocation to unsecured and uninsured creditors in resolution and liquidation, notably for LSIs for which a resolution strategy is foreseen; and strictly limit the use of public funds to exceptional events that could undermine system-wide financial stability.	The resolution planning activity progressed significantly in the last years and a resolution plan has been drafted for all the Italian LSI; such plans are updated annually or every 2 years (in case of application of simplified obligations). A binding MREL target has been set according to BRRD2, being equal to the loss absorption amount in case liquidation is the preferred resolution strategy and including also a recapitalization amount and a market confidence charge in case resolution is the preferred strategy. In the former case, the BdI assesses whether it is justified to limit the MREL requirement to the loss absorption amount, taking into account any possible impact on financial stability and on the risk of contagion to the financial system; in the latter case, transitional periods are envisaged, where needed, in order to allow banks to comply with the requirement in an adequate timeframe. In relation to the refinement of the resolution planning activity, for LSI whose failure could present systemic risks, resolution has been identified as preferred resolution strategy. In this regard, resolvability assessments activities have been expanded for these LSI, in line with the EBA Guidelines for institutions and resolution authorities on improving resolvability and with the SRB policy. In particular, banks were given a three years phase-in period for completing the	The LSIs resolution planning activity is fully in force, with a periodical update of the plans by the Resolution Authority (RA). In this context, MREL binding target are set according to BRRD2/SRMR2, envisaging an adequate buffer to recapitalize the entity and sustain sufficient market confidence in case of resolution as preferred resolution strategy (PRS). Some further in depth analyses are currently ongoing in order to better support the public interest assessment for the determination of the preferred resolution strategy, also in case of systemic wide events. In terms of operational capabilities, a comprehensive Manual for crisis management and resolution has been finalised in November 2020, covering all the different aspects of the resolution activity, and is periodically updated in order to take into account the evolution of the regulatory framework and of the related policies. Moreover, in 2021 the Banca d' Italia (BdI) took part in an EU level dry-run, aimed at enhancing crisis preparedness and testing the functioning of the procedures in a Resolution College. As for the recommendation related to public funds, the use of public funds limited to exceptional events that could undermine financial stability is a policy line agreed and followed by the Italian authorities. Indeed, the European Commission (DG-COMP) strictly monitors this issue, allowing the use of national public funds for managing bank crises only in the specific circumstances envisaged by EU regulations. BdI's view is that those events should not be necessarily limited to cases with an impact on system-wide financial stability, as stated by the IMF but, based on specific market conditions, they could comprise also those	BdI, MEF	ST

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Reinforcing Crisis Management and Safety Nets				
	analysis and undertake necessary steps to ensure full resolvability. Specific areas of priority, depending also on the resolution tool, have been agreed with the banks, including also analyses on the perimeter for asset and liability to be transferred in resolution; the separability of the associated activities; banks' ability to promptly provide the necessary information for valuation purposes; and the identification of potential acquirers. A comprehensive Manual for crisis management and resolution has been finalized in November 2020, covering all the different aspects of the resolution activity, and is periodically updated in order to take into account the evolution of the regulatory framework and of the related policies, together with the experience gained and lessons learnt. The use of public funds limited to exceptional events that could undermine financial stability is a policy line agreed and followed by the Italian authorities. Indeed, the European Commission (DG-COMP) strictly monitors this issue, allowing the use of national public funds for managing bank crises only in the specific circumstances envisaged by EU regulations. The BdI's view is that those events should not be necessarily limited to cases with impact on system-wide financial stability, based on specific market conditions, they could comprise also those events having effect only at regional or multi-	events having effect only at regional or multi-regional level that could unpredictably cause a deep impact on financial stability and real economy.		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Reinforcing Crisis Management and Safety Nets				
	regional level that could unpredictably cause a deep impact on financial stability and real economy.			
Reinforce the DGS by removing active bankers from their boards; assessing the adequacy of funding targets; strengthening backstops; and avoiding the use of	Notwithstanding that Italian DGSs are established as private law consortia and are totally independent in their decision-making process, the FITD has promoted and the BdI has approved a by-law amendment in which: i) the independence of the Chair of the Board is streamlined and strengthened; ii) the independence of one the Board members is introduced. Further increases of the degree of independence of the Italian DGSs' Board will be discussed in the future. The Decree of the Italian Minister of Finance n. 169/2020 , according to the Italian Banking Law, envisages the application of fit and proper requirements (including independence requirements) also to DGS in line with a proportionality principle. Concerning funding targets, the current target level of 0.8% of covered deposits is a minimum requirement envisaged by the legislative European framework (DGSD). The resources collected so far are in line with the funding path for meeting the target at the end of the transitional period. Moreover, such target is the same set by the majority of other European countries. If a higher target was set or an accelerating process for collecting contributions was realized, an issue of level playing field at European level	With reference to DGSs and safety nets, the national DGS (FITD) has recently taken measures that move in the direction indicated by the IMF recommendations. Indeed, the DGS has promoted and the Banca d' Italia has approved a by-law amendment in which the independence of the Chair of the Board is streamlined and strengthened. Further increases of the degree of independence of the FITD Board could be discussed in the future.	DGS, BdI, MEF	ST

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Reinforcing Crisis Management and Safety Nets				
	would arise, with possible distortions in competition (in case the increase of the target level above the 0.8% was not followed by other European jurisdictions), as such measures could negatively impact on the profit and loss accounts of Italian institutions. The FITD has in place a funding agreement (€3.5 bn) with a pool of major banks that can be activated also if the available financial means (AFM) are insufficient to perform an intervention. The loan will be repaid with the recoveries of the intervention, with the AFM or with extraordinary contributions. The repayment will take place gradually, so as to assure a timely payout without any adverse effect (caused by the calling of the extraordinary contributions) on the banking system as a whole. With reference to the FGDCC, a credit line agreement is going to be finalized with the two "parent companies" of the two cooperative banking groups and the "managing institution" of the Institutional Protection Scheme.			
Avoiding the use of DGS resources for failure prevention outside of resolution or liquidation as much as possible, only using it in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability.	The BdI disagrees on avoiding the use of DGS resources for failure prevention outside of resolution or liquidation as much as possible. Indeed, in Italy the so-called “preventive interventions” have been successful over the last 20 years. These interventions, explicitly envisaged by the European legislation and by the IADI Core Principles, can be a helpful instrument to prevent bank	Finally, BdI disagrees on avoiding the use of DGS resources for failure prevention outside of resolution or liquidation as much as possible. Indeed, in Italy the so-called “preventive interventions” have been successful over the last 20 years. These interventions, explicitly envisaged by the European legislation and by the IADI Core Principles, can be a helpful instrument to prevent or face bank crises at an initial stage, before they evolve in resolution or liquidation. BdI agrees on using		

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Recommendations	Implementation Status[1] - 2023	Implementation Status[1] - 2022	Agency	Time[2]
Reinforcing Crisis Management and Safety Nets				
	crises at an initial stage, before they evolve in resolution or liquidation. Bank of Italy agrees on using preventive intervention only in presence of strong prospects for ensuring successful rehabilitation and long-term viability; in 2021 the FITD has promoted and the BdI has approved a by-law amendment that move in this direction. As regard the FGDCC, the likelihood of the DGS intervention may be reduced after the set-up of the two cooperative banking groups and the Institutional Protection Scheme.	preventive intervention only in presence of strong prospects for ensuring successful rehabilitation and long-term viability.		

[1] Prepared based on the inputs from the Italian authorities.

[2] C = Continuous; I = Immediate (within one year); ST = Short Term (within 1–2 years); MT = Medium Term (within 3–5 years)

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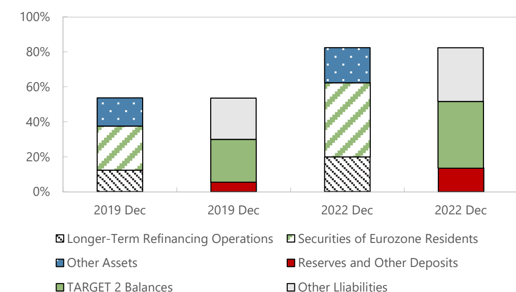
Annex VI. The Bank of Italy's Profits and Consolidated Public Sector Considerations

1. Pandemic-related monetary stimulus programs caused the BdI's balance sheet to expand significantly. An increase in securities holdings under ECB asset purchase programs as well as subsidized funding-for-lending to banks (TLTROs) caused the BdI's total assets to jump by 50 percent from 2019 to 2021 before retreating slightly at end-2022 owing to partial TLTRO repayments by banks. On the liabilities side, asset acquisition was largely funded by an increase in reserves and TARGET 2 liabilities.

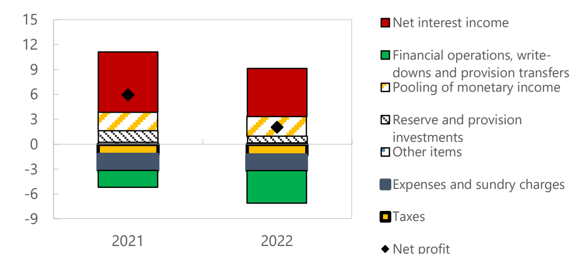
Bank of Italy's Balance Sheet
(Percent of 2019 GDP)



Sources: Bank of Italy and IMF staff calculations.

2. Following several years of strong profits, the BdI recorded a large decrease in 2022 as policy interest rates rose sharply. The decline in profit from €5.9bn in 2021 to €2.1bn in 2022 reflected mainly write-downs and the increase in interest payments while interest rates on assets were broadly unchanged. With securities recorded at amortized cost, no valuation change is recorded if they are held to maturity.[1] In addition, the pooling of net interest payments and receipts on Target 2 balances net out and do not impact central bank profit.

Bank of Italy Profit Composition
(Billions of euros)



Source: Bank of Italy.

3. The BdI expects further deterioration in net interest income to lead to losses in 2023-24, which can be fully covered by accumulated reserves. Based on the end-2022 balance sheet, staff estimates a zero-profit policy rate of 2.5 percent, against the current policy rate of 3.5 percent, and with higher rates lowering profits. Changes in the size and composition of the balance sheet are also relevant. For example, banks' repayments of TLTROs will shrink both sides of the BdI's balance sheet, but with little net effect on income as the TLTRO interest rate is indexed to the rate paid on reserves. On the other hand, any reinvestment of maturing fixed income securities will likely result in higher coupon rates than those on maturing securities, adding to net interest income. This effect could gradually come to dominate the evolution of BdI net interest income over the medium term, as three quarters of the securities held for monetary policy purposes have residual maturities beyond 2 years. The BdI has total equity of €26.3 bn in 2022, equivalent to 1.8 percent to total assets (€1.48 trillion). Some €35bn in general risk provisions accumulated from past profits is available to cover any future losses.

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[1] All balance sheet items associated with monetary policy operations are recorded at amortized cost.

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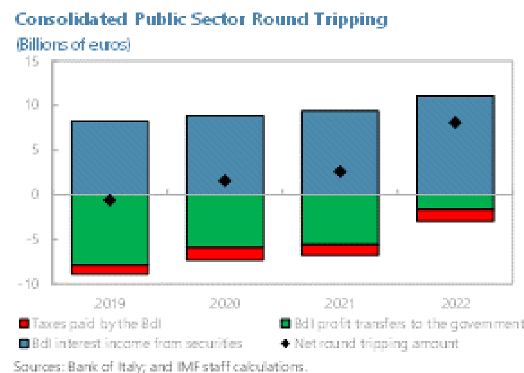
4. Lower profit or a shift to losses could reduce transfers to the government but with a smaller effect from a consolidated public sector perspective. For 2022, the transfer is announced to decline to €1.7bn. Round tripping of payments and receipts within the consolidated public sector (general government and central bank; (CPS)) reduces this impact. Specifically, the general government pays interest to the BdI on its sovereign bond portfolio while transferring part of its profit—and also taxes—back to the government. This helps reduce the effective interest bill for the government.

Consolidated Public Sector Round Tripping

(Billions of euros)



Sources: Bank of Italy; and IMF staff calculations.

5. Moreover, from a CPS perspective, the average maturity of liabilities is below the 7 years associated with government debt, and consolidated liabilities are more sensitive to interest rate changes. Netting out government bonds held by the BdI gives a CPS balance sheet where liabilities have a much shorter duration than the duration of general government debt. With about 50 percent of GDP in CPS liabilities relating to BdI floating-rate liabilities in the form of bank reserves and TARGET 2 balances and with nearly 40 percent of government debt outside the BdI having less than one-year residual maturity or at variable rates, about 100 percent of GDP in CPS liabilities carry interest rates that could reset each year or more frequently.

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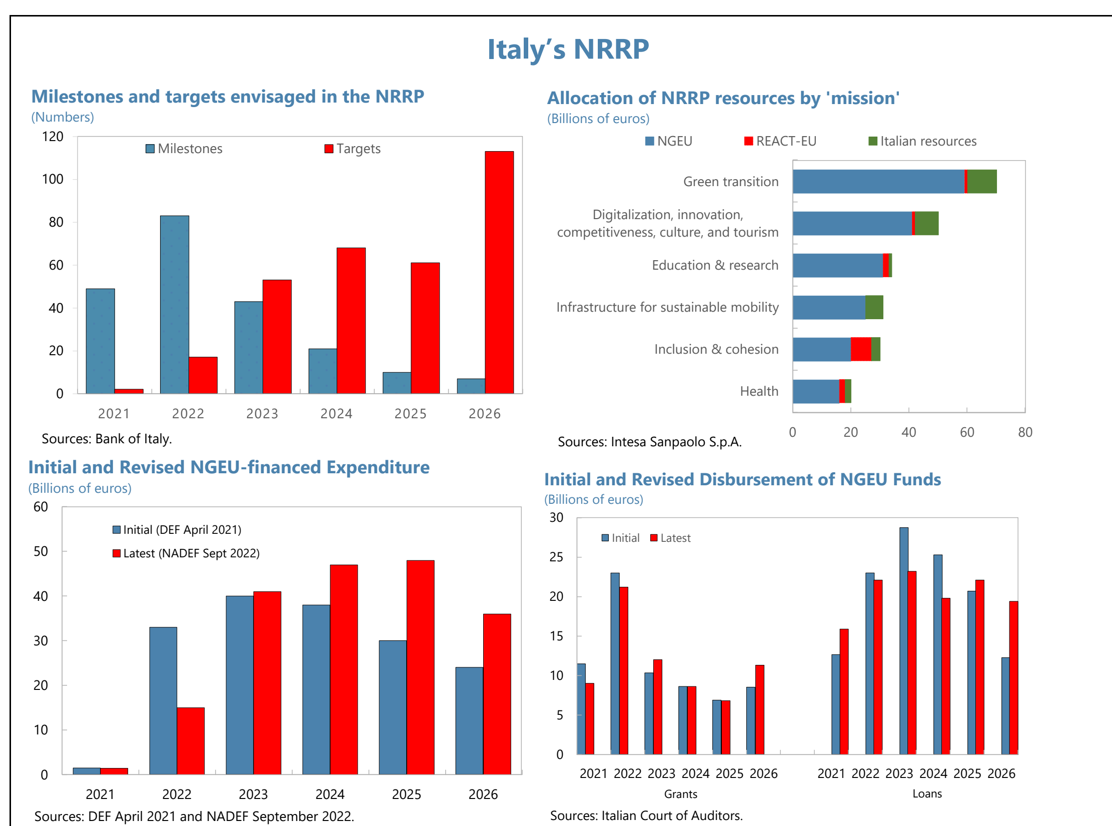
Annex VII. National Recovery and Resilience Plan Implementation

1. Italy's National Recovery and Resilience Plan (NRRP) is large and ambitious. The Plan aims to modernize Italy's economy through 63 reforms and 134 investments supported by €236 billion (€191.5 billion of NGEU grants and loans, €13 billion from REACT-EU, and €31 billion from national resources). The NGEU funding is scheduled to be disbursed in ten 6-monthly payments, subject to satisfactory achievement of over 500 qualitative 'milestones' (linked to key steps in implementing reforms and investments), and quantitative 'targets' (linked to investments). So far, Italy has received almost €67 billion (a prepayment and the first two tranches). The deadline for completingthe Plan is August 31, 2026. The NRRP comprises six areas, with the green transition, digitization, and innovation accounting for half the resources.



2. The NRRP frontloaded reforms; investments scheduled for the second half of the plan face delays. Reforms are intended to improve the efficiency of subsequent investments. Accordingly, over 70 percent of total milestones are linked to the first five installments. The focus is now shifting towards meeting investment-related targets. However, spending is hindered by rising costs and skilled staffing shortages. Excluding tax credits, spending through end-2022 was about a third of the planned €34 billion. The parceling of NRRP investments into almost 170 thousand individual projects is straining the administrative capacity of implementing municipalities (tasked with executing nearly 60 percent of projects by number). Recruitment challenges further impede the progress: the Bank of Italy estimates that fully implementing the NRRP requires filling up to 375,000 new jobs (about 2 percent of employment), mostly in construction and small hi-tech sectors.

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Annex VIII. Transnational Aspects of Corruption

Supply-side of Corruption

1. A recent report by the OECD Working Group on Bribery[1] evaluates Italy's implementation of the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The report, published in October 2022, highlights notable achievements of Italy in fighting foreign bribery, but also notes critical issues that should be addressed by Italian authorities in order to promote further progress in the implementation of the Convention.

2. The Working Group on Bribery commended Italy for strengthening its legislative framework to fight foreign bribery and for its significant level of enforcement of the foreign bribery offence with the pace of enforcement increasing since 2011. Legislative improvements include lengthening the statute of limitations for natural persons, increasing the available imprisonment terms and disqualification sanctions and introducing whistleblower protection. The report noted the increasing number of investigations and prosecutions, including proceedings against legal persons. The Working Group on Bribery also commended Italy for the substantial investment that has been committed to digitalise and modernise the judiciary as well as for the significant contributions to anti-corruption efforts in multiple international fora and for promoting the OECD Convention. Further positive developments highlighted in the report concern Italy's concerted efforts to strengthen its legal and policy framework for mutual legal assistance and extradition. The Working Group acknowledged commendable improvements in cooperation between tax and law enforcement authorities, resulting in the detection of three foreign bribery cases.

3. The OECD report also noted some critical issues that might impede Italy's further progress in fighting foreign bribery. The Working Group expressed concerns about the high number of dismissals in foreign bribery cases litigated in court, since almost all foreign bribery convictions have been secured through a form of non-trial resolution (*patteggiamento*). In this regard, the Working Group recommended that Italy provide more specific training for judges and prosecutors focusing on circumstantial evidence and elements of the offence of foreign bribery as envisaged in the Convention. According to the report, Italy should strengthen its legislation for holding companies accountable for foreign bribery: corporate fines are deemed too low and the statute of limitations is considered to be too short when compared with that provided for individuals. The Working Group also noted that further efforts are needed to raise awareness of foreign bribery and the Convention among Italian officials, accountants and auditors, and small and medium size enterprises. The report recommended that Italian authorities proactively encourage companies to

[1]Information relating to supply-side corruption in this section of the Report draws on the WGB's Phase 4 Report of Italy, October 2022. The IMF and Italy have provided additional views and information whose accuracy have not been verified by the WGB or the OECD Secretariat, and which do not prejudice the WGB's monitoring of the implementation of the OECD Anti-Bribery Convention.

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adopt anti-corruption compliance programmes and enhance the legislative framework for the protection of whistleblowers both in the public and private sector.

Concealment-side of Corruption, including AML/CFT Aspects

4. Italy continues to strengthen the operational and institutional effectiveness of its AML/CFT framework. In 2022 a dedicated AML Supervision and Regulation Unit was set up within the Bank of Italy to deal with the growing complexity of AML/CFT supervision of the banking and financial system. Similarly, the Financial Intelligence Unit (*Unità di Informazione Finanziaria* or UIF) made efforts to reinforce its analytical capacities to produce relevant and timely financial intelligence. A new Directorate was created within the UIF in February 2023 to support its operational activities and to facilitate the use of advanced IT tools, including artificial intelligence technologies, for the classification, selection, and management of the data derived from suspicious transaction reports, threshold-based reports, and other forms of reports filed by banks and other AML/CFT obliged entities. In the broader context of financial crimes oversight, Italy should consider developing a national AML/CFT strategy or action plan that could help set clear priorities and ensure national coordination between the various competent authorities. The close inter-agency cooperation with *Guardia di Finanza*, the economic and financial police, should continue to be viewed among the priorities of an effective and risk-based AML/CFT regime in Italy. That is given the preponderance of tax evasion proceeds in money laundering cases, along with corruption and drug-trafficking proceeds.

5. Important steps have been taken to implement the beneficial ownership register, but more remains to be done. The beneficial ownership register was established based on the Implementing Decree No. 50 on March 11, 2022 adopted by the Ministry of Economy and Finance (MEF) along with the Ministry of Enterprises and Made in Italy (MIMIT). In line with the EU AML Directives, the register would extend to beneficial ownership on both legal entities and legal arrangements such as trusts. Since the adoption of the above decree, Italy has commenced an awareness campaign targeted at relevant legal entities. However, for the register to become operational additional implementing decrees need to be adopted by the MIMIT. The first of these, the Technical Specification Decree, was adopted on April 20, 2023. Italy should adopt the outstanding Administrative Fees Decree without undue delay and ensure entry into force of the register which has been established now over one year ago. The authorities should further ensure that the beneficial ownership register is not a mere passive repository of unverified information and institute the necessary procedures and processes to ensure validation of the information submitted. It is important that the beneficial ownership contained therein is adequate, accurate, and up-to-date.

6. Italy has further taken measures to address the new and emerging risks stemming from virtual assets. Pursuant to the MEF Decree from January 13, 2022, all virtual assets service providers (VASPs) need to register with the *Organismo Agenti e Mediatori* (OAM) to legally operate in Italy. VASPs operating in Italy are further subject to the Italian AML/CTF legislation, and must put in place all the arrangements, procedures, and controls necessary to ensure compliance. Italy should ensure effective enforcement of the registration requirement and put in place effective supervisory mechanisms in terms the applicable AML/CFT controls.

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INTERNATIONAL MONETARY FUND

ITALY

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

July 6, 2023

Prepared By

European Department
(In consultation with other departments)

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FUND RELATIONS

(As of May 31, 2023)

Membership Status: Joined March 27, 1947; Article VIII.

General Resources Account:	SDR Million	Percent Quota
Quota	15,070.00	100.00
Fund holdings of currency	10,849.75	72.00
Reserve Tranche Position	4,220.34	28.00
Lending to the Fund		
New arrangements to borrow	39.89	
SDR Department:	SDR Million	Percent Allocation
Net cumulative allocation	21,020.03	100.00
Holdings	21,862.15	104.01

Outstanding Purchases and Loans: None

Financial Arrangements: None

Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2023	2024	2025	2026	2027
Principal					
Charges/Interest		0.28	0.28	0.28	0.28
Total		0.28	0.28	0.28	0.28

Exchange Rate Arrangements: The currency of Italy is the euro. The exchange rate arrangement of the euro area is free floating. Italy participates in a currency union (EMU) with 19 other members of the EU and has no separate legal tender. The euro, the common currency, floats freely and independently against other currencies.

Italy accepted the obligations under Article VIII, Section 2(a), 3, and 4 of the IMF's Articles of Agreement, and maintains an exchange system free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Italy solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultations: Italy is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 2–17, 2022; the staff report (IMF Country Report No. 22/255) was discussed by the Executive Board on July 27, 2022.

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ROSCs/FSAP:

Standard Code Assessment	**Date of Issuance**	**Country Report**
Fiscal Transparency	October 9, 2002	No. 02/231
Data	October 18, 2002	No. 02/234
Fiscal ROSC update	November 2003	No. 03/353
Fiscal ROSC update	February 2006	No. 06/64
FSAP	September 2013	No. 13/300
FSAP	March 2020	No. 20/81

Technical Assistance:

Year	**Department/Purpose**
2007	FAD: Public Expenditure Management
2012	FAD: Tax Policy
2015	FAD: Tax Administration

Data: Italy subscribes to the Fund's Special Data Dissemination Standard plus, and comprehensive economic data are available on a timely basis (Table 1).

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STATISTICAL ISSUES

(As of June 30, 2023)

I. Assessment of Data Adequacy for Surveillance	
General: Data provision is adequate for surveillance. Italy's economic and financial statistics are comprehensive and of generally high quality. Data are provided to the Fund in a comprehensive manner (Table 1). The authorities regularly publish a full range of economic and financial data, as well as a calendar of dates for the main statistical releases. Italy is also subject to the statistical requirements of Eurostat and the European Central Bank (ECB), including the timeliness and reporting standards, and it has adopted the *European System of Accounts 2010* (*ESA2010*).	
National Accounts: Further improvements should be considered regarding changes in inventories in the quarterly national accounts, which are currently derived as a residual and lumped together with the statistical discrepancy.	
Government Finance Statistics: Annual and quarterly consolidated general government operations and financial balance sheet data are reported, with extensive time series. Component details on stock positions in assets and liabilities by counterparty sector are not available.	
Monetary and Financial Statistics: The ECB reporting framework is used for monetary statistics and data are reported to the IMF through a "gateway" arrangement with the ECB for publication in the IFS. Monetary statistics for Italy are published in the IFS cover data on central banks and other depository corporations (ODCs) using Euro Area wide residency criterion. Italy reports data on key series and indicators of the Financial Access Survey (FAS), including the two indicators (commercial bank branches per 100,000 adults and ATMs per 100,000 adults) adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (SDGs).	
Financial Sector Surveillance: Italy participates in the IMF's financial soundness indicators (FSIs). The Italian authorities report all of the 12 core FSIs and 11 of the 13 encouraged FSIs for deposit takers semi-annually to the IMF and quarterly on their National Summary Data Page. In addition, 12 FSIs for other sectors are compiled and reported. FSI reporting is timely.	
External Sector Statistics: The Bank of Italy adopted the standards for reporting Balance of Payments (BOP) and International Investment Position (IIP) data on the basis of the Balance of Payments and International Investment Position Manual, 6th edition (BPM6) in the second half of 2014. In addition, Italy reports the International Reserves and Foreign Currency Liquidity Template (IRFCL) data and participates in the IMF's Coordinated Direct Investment Survey (CDIS) and Coordinated Portfolio Investment Survey (CPIS).	
II. Data Standards and Quality	
Italy has subscribed to the Special Data Dissemination Standard (SDDS) since 1996 and posts its metadata on the Dissemination Standards Bulletin Board (DSBB). In 2015 Italy adhered to SDDS Plus, together with the first group of adherents. **Implementing G-20 DGI recommendations:** Italy has achieved compliance with the core requirements in relation to many DGI recommendations for which data templates have been already defined. Further progress in the future is likely to be made on the reporting frequency of Financial Soundness Indicators.	A data ROSC was disseminated in 2002.

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Table 1. Italy: Common Indicators Required for Surveillance
(As of July 06, 2023)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jul 06, 2023	Jun 06, 2023	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2023	Jun 2023	M	M	M
Reserve/Base Money	Apr 2023	Jun 2023	M	M	M
Broad Money	Apr 2023	Jun 2023	M	M	M
Central Bank Balance Sheet	Apr 2023	Jun 2023	M	M	M
Consolidated Balance Sheet of the Banking System	Apr 2023	Jun 2023	M	M	M
Interest Rates[2]	Jul 06, 2023	Jul 06, 2023	D	D	D
Consumer Price Index	Jun 2023	Jul 2022	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Apr 2023	Jun 2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]— Central Government	Apr 2023	Jun 2023	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Apr 2023	Jun 2023	M	M	M
External Current Account Balance	Apr 2023	Jun 2023	M	M	M
Exports and Imports of Goods and Services	Apr 2023	Jun 2023	M	M	M
GDP/GNP	Q1:2023	May 2023	Q	Q	Q
Gross External Debt	Q1:2023	Jun 2023	Q	Q	Q
International Investment position[6]	Q1:2023	Jun 2023	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

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Statement by Mr. Giammusso on Italy
July 17, 2023

We thank staff for the informative set of papers and the fruitful engagement for Italy's 2023 Article IV Consultation. The Italian authorities highly value staff's analyses and broadly share the policy recommendations although the Government is generally more optimistic than staff on Italy's outlook and on the assessments of sovereign risk and external sector position. The authorities are committed to continue improving public finances by steadily reducing the public deficit- and debt-to-GDP ratios and phasing out the measures adopted to respond to the energy crisis induced by Russia's war of aggression against Ukraine. The authorities are fully determined to increase Italy's potential growth through effective implementation of the National Recovery and Resilience Plan (NRRP), which focuses on important priorities like decarbonization, digitalization, infrastructure, sustainable mobility, education, health, cohesion, and social inclusion. The rate of implementation of the NRRP has largely proceeded in line with plans; some fine-tuning of the NRRP is ongoing to refine it and make it better attuned to the changed external circumstances.

Macroeconomic Developments and Outlook

The authorities wish to underline the remarkable resilience of Italy's economy to the materialization of multiple shocks, as the country has shown a performance above the EU average when recovering from the pandemic and the energy price spikes induced by Russia's war of aggression against Ukraine.

The economy continued to grow at a brisk pace in 2022 despite several headwinds including the energy crisis, high and rising inflation, and the tightening of financial conditions. Last year GDP growth was mainly driven by the recovery in the services sector and benefited from the expansion of household consumption, supported by the savings accumulated during the pandemic and the fiscal support measures, despite the drop in purchasing power related to high inflation. Although economic activity marginally contracted in the final quarter of 2022, it turned again into a robust expansion in the first quarter of this year. It is worth noting that even modest growth outturns in the remaining quarters of 2023 would be enough to beat the official growth projection of 1.0 per cent for the whole 2023 set last April in the 2023 Economic and Financial Document. At 1.1 percent, staff's projection is marginally higher than the official one.

Headline inflation reached a peak in late 2022 but has since come down sizably; core inflation has so far proved more persistent although it has also shown signs of moderation more recently.

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There has so far been no indication of a wage-price spiral because of Italy's prudent institutional framework that relies on a benchmark for social partners' wage negotiations based on an independent projection of the expected domestic inflation net of imported energy that the Statistical Institute (ISTAT) elaborates each year. The authorities expect some pick up in wage developments this year to be followed by a rapid moderation in 2024. **The labor market has shown noteworthy improvements**: at about 23.5 million, the number of persons employed is at a historic high, driven notably by the robust labor demand from the construction and the services sectors. The participation rate has exceeded the pre-COVID level while the unemployment rate has continued along a downward trend; productivity also posted moderate gains in 2022.

Overall, the authorities see risks to the outlook as somewhat more balanced rather than skewed on the downside as assessed by staff and agree that tourism is an upside risk. The authorities note that staff's trend growth for Italy's economy has been marginally upgraded to an annual average of 0.9 percent for the 2014-2019 period and staff's growth outlook for Italy has been improved twice since the start of this year. We underline the prudence of the official growth and fiscal projections that only marginally incorporate the effects on productivity and labor supply associated with the implementation of the NRRP in the growth estimates.

Public Finances

The authorities have enacted strong and timely policy measures to counteract the size of external shocks, while being cognizant of the need to prudently manage public finances. **Although the pandemic caused a rise in Italy's public debt ratio of 20 percentage points of GDP, half of that increase has already been reversed in 2021 and 2022**. **The authorities are fully committed to** (i) **steadily bringing the public debt-to-GDP ratio back to pre-pandemic levels by 2030** that, in staff's projections, seems an achievable target already in 2028; (ii) **further reducing the deficit-to-GDP ratio**; and (iii) **gradually rebuilding a primary balance surplus of 2 percent of GDP by 2026**.

In line with staff's recommendations, **the fiscal support to moderate the impact of shocks in relation to the energy price spikes has become smaller over time and better focused to the vulnerable households**, with about a 60 percent rate of closely targeted measures currently. Public resources allocated to mitigate the energy shock have been more than halved, down from 2.8 per cent of GDP in 2022 to 1.2 percent this year and will be phased out in 2024-2025. Similarly, in line with staff's recommendations, **the amount of the tax credit to make residential buildings more energy efficient** – the so-

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called “Superbonus” – **has been markedly reduced this year** in consideration of the large impact that it has had on public finances. Moreover, the authorities intend to comprehensively review all tax credits that support buildings’ efficiency also considering the distributional impact of the measures. **Regarding social policy, the citizens’ income has been abolished as of January 1st, 2024, and replaced by two measures. The Inclusion cheques** will be reserved for those who must care for underage, elder, or disabled family members; the **Aid to vocational training** will provide stronger incentives to job participation and will be reserved to unemployed people who are both ineligible for Inclusion cheques and actively looking for a job.

Despite the tightening in financial conditions, the increase in Italy’s public interest bill as a share of GDP is expected to remain contained over the medium term aided by the long average maturity of public debt which stood at 7.7 years at end 2022. Since last October, the spread of Italy’s government bonds has gradually tightened, moving from 250 bps to around 170 bps, despite turbulences in global and regional financial markets in early 2023 due to stress in other countries’ banking sectors. Italian retail domestic investors have so far shown a strong appetite for the purchase of domestic government bonds and there seems to be room to increase the share of public debt held by the household sector.

Regarding the new Fund’s sovereign risk and debt sustainability analysis, **the authorities agree with staff’s assessment that Italy’s overall risk of sovereign stress is “moderate” but do not share staff’s characterization of this assessment being “on the borderline” and “sensitive to small policy deviations”**. In the authorities’ view, these judgements do not seem to be adequately corroborated by evidence, and look quite peculiar on a comparative basis, also considering that the new sovereign risk stress indicator is in its early stage of implementation across the Fund’s membership. Bearing in mind the sizable progress achieved by Italy’s banking system across recent years, the authorities deem that the scenario triggered by staff of a possible banking crisis is not particularly pertinent to Italy. The country has a good track record of attaining comparatively high primary surpluses as a share of GDP, and official forecasts incorporate a high degree of caution. **All these mitigating factors could have been better reflected in the overall assessment of the sovereign stress risk indicator for Italy**.

Banking Sector

The financial situation of the Italian banking system is sound overall, with banks well capitalized, liquid, and profitable. **Profitability, long compressed by low interest**

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rates and high credit losses, has risen significantly in 2022, and is expected to remain positive in 2023 (the ROE for significant institutions was 13.5 percent in March 2023), driven by net interest income growth and, to a lesser extent, by the reduction in loan loss provisions reflecting the current low default rates. **Capital adequacy is above pre-pandemic levels** (it decreased slightly in March 2023 for significant institutions, to 15.4 percent, but it is still above pre-pandemic levels). **Assets eligible as collateral for Eurosystem refinancing operations continue to be widely available.** The Italian banking system has been barely hit by the bank failures in some jurisdictions in March-April 2023, also owing to the limited direct exposures thereto. Asset quality does not show signs of worsening so far. **The share of non-performing loans (NPLs) has remained stable, at low levels and in line with the European average.** In 2022, around €20 billion in NPLs were sold, contributing to a further decline of the NPL ratio, net of loan loss provisions, slightly down to 1.5 per cent (the figure was 1.1 per cent in March 2023 for significant institutions).

The stability of the Italian banking system is the result of an intense decade-long process of cleaning up balance sheets, improving efficiency, and strengthening corporate governance and internal controls. More recently, Italian banks have handled successive waves of crises following the outbreak of the pandemic, starting from a stronger position than they had in past crises, which has allowed them to provide credit to firms and households through the most difficult phases, including by channeling public intervention aimed to support private sector's credit and liquidity. **This result is also attributable to the regulatory reforms agreed at European level and introduced after the global financial crisis and to rigorous supervision.**

To address some remaining weaknesses for the less significant institutions, important reforms were phased in over the years regarding the *popolari* banks and the cooperative credit banks. In recent years, among other things, the Bank of Italy considerably raised the Pillar 2 capital requirements set by supervisory authorities in addition to the minimum ones. The Bank of Italy is now focusing on examining the sustainability of business models and the associated risks, also taking into account the impact of technological innovation on the financial system.

The main risks for the banking system stem from global geopolitical uncertainty, the cyclical slowdown, and the medium-term effects of the increase in interest rates on customers' ability to service their debts. Rising interest rates have caused the value of portfolio securities to fall. The unrealized losses on those securities that banks plan to hold until maturity, estimated to have an average impact of 200 basis point on the CET1 ratio, would only materialize if banks were compelled to sell them before maturity. Less

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than 2 per cent of these unrealized losses are currently accounted for by banks with a relatively low liquidity coverage ratio. The mechanism that regulates the use of central bank asset-backed refinancing in the euro area helps to lower the probability that banks will have to liquidate their portfolio securities before maturity. Upward pressures on the cost of funds may partly arise from the need to continue to replace the funding acquired through the Eurosystem's third targeted longer-term refinancing operations (TLTRO III) and to issue instruments that satisfy the minimum requirement for own funds and eligible liabilities (MREL); however, the expected impact on profitability is assumed to be manageable. In particular, **the repayment to the ECB of the TLTRO funds on the side of the Italian banks is not expected to be a source of material stress, since the banks show large liquidity buffers and can count on a large amount of unencumbered high-quality collateral that can be used in repo operations both on the markets and with the ECB.** Banks' market valuations have remained favorable, with declining Credit Default Swaps prices.

The ongoing tightening of financing conditions may have some impact in the medium-to-long run, but households and non-financial firms have relatively robust financial positions and moderate debt-to-GDP ratios in the international comparison. **Italy's residential sector does not show any significant imbalances.** House prices have showed only modest gains in recent years and the increase in both prices and house purchase volumes have recently come to a halt. In recent years in Italy also the commercial real estate sector experienced smaller price increases than in other countries, and the supervisory authority is monitoring closely the relevant bank exposures.

External Sector

As a result of the significant deterioration in the energy trade balance (over 5 percent of GDP) following Russia's war of aggression against Ukraine, Italy's 2022 current account recorded a deficit of 1.3 percent of GDP, the first in a decade. However, Italy's export market shares and competitiveness trends have performed well over recent years. **The return of Italy's current account to a surplus position of about 1 percent of GDP has already materialized in early 2023**, and the official forecasts project sustained improvements towards the pre-crisis surplus levels, given that that the energy price shock has reversed, and global energy prices are back to 2021 levels. Therefore, **the Italian authorities disagree with the staff's assessment that, in 2022, Italy's external position was "*weaker than the level implied by medium-term fundamentals and desirable policies*" and instead believe that, like in the past years, Italy's position is "*broadly in line with fundamentals and desirable policies*"** once adequate adjustments are factored in to reflect the impact of the exceptional and temporary energy crisis. In

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2022 Italy's external sector was hit by a huge – but largely temporary – external shock, related to the unprecedented peaks reached by the price of natural gas in Europe. **In the authorities' view, Fund staff did not sufficiently consider these features of the shock when appraising the country's external position**. Moreover, at 3.4 percent of GDP, the Fund's External Sector Assessment model estimates a very high current account norm for Italy, which is quite distant from similar methodologies elaborated by other international institutions like the European Commission that, for Italy, evaluates a current account norm that is less than half compared to the staff's norm. **Besides, the assessment of Italy's external position should also consider the historically large surpluses in the capital account driven by Next Generation EU transfers in 2022** (0.5 percentage points of GDP based on the most recently available data) **and in the following years until 2026**. While these transfers temporarily increase imports via the investment channel, thus worsening the current account balance in the short term, they represent additional resources in the receiving economy that are mainly recorded in the capital account. Additionally, as NGEU financed investments are aimed at facilitating the digital and green transition, they contribute to boost productivity in the medium term, in turn improving the country's external position.

Conclusions

Italy has continued to successfully navigate a series of shocks and difficult policy trade-offs during uncertain times. **Economic growth has recovered strongly** and better than in previous downturn episodes, which constitutes a sign of a more robust economy. Since its start as well as in the following steps, **the new Government has adopted a prudent and consistent fiscal stance** aimed at both ensuring public debt sustainability and contributing to keeping inflation on a downward path. **The financial sector is healthy**, has sustained the ongoing economic recovery and is in stronger conditions to withstand adverse shocks than in the past. **The NRRP is an opportunity**: its effective and timely implementation will contribute to improve significantly medium-term growth, employment, and social inclusion. Italy is proceeding with the implementation of the Plan despite the unpredictable evolution of the macroeconomic scenario in recent years. **The constructive dialogue with the European Commission on the assessment process of the third payment request has continued tirelessly and is now coming to an end. As for the fourth tranche, Italy has submitted the request to the European Commission to amend a specific set of milestones and targets** aimed at incorporating objective circumstances that have occurred over the last year in relation to the disruptions to global supply chains and high inflation due to Russia's war. **We are confident to complete this process shortly.**

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