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Macroeconomic Imbalances - Italy 2014

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Italy is experiencing *excessive macroeconomic imbalances, which require specific monitoring and strong policy action*. In particular, the implications of the very high level of public debt and weak external competitiveness, both ultimately rooted in the protracted sluggish productivity growth, deserve urgent policy attention. The need for decisive action so as to reduce the risk of adverse effects on the functioning of the Italian economy and of the euro area, is particularly important given the size of the Italian economy. The Commission intends to put in motion a specific monitoring of the policies recommended by the Council to Italy in the context of the European Semester, and will regularly report to the Council and the Euro Group.

More specifically, high public debt puts a heavy burden on the economy, in particular in the context of chronically weak growth and subdued inflation. Reaching and sustaining very high primary surpluses – above historical averages – and robust GDP growth for an extended period, both necessary to put the debt-to-GDP ratio on a firmly declining path, will be a major challenge. In 2013, Italy has made progress toward its medium-term fiscal objective. However, there is a risk that the adjustment of the structural balance in 2014 is insufficient given the need to reduce the very large public debt ratio at an adequate pace. The crisis has eroded the initial resilience of the Italian banking sector and weakens its role to support the recovery of the economy. The losses of competitiveness are rooted in a continued misalignment between wages and productivity, a high labour tax wedge, an unfavourable export product structure and a high share of small firms which find it difficult to compete internationally. Rigidities in wage setting hinder sufficient wage differentiation in line with productivity developments and local labour market conditions. Long-standing inefficiencies in the public administration and judicial system, weak corporate governance, and high levels of corruption and tax evasion reduce the allocative efficiency in the economy and hamper the materialisation of the benefits of the adopted reforms. Large human capital gaps – reflecting low returns to education for younger generations, the country's specialisation in low-to-medium technology sectors and structural weaknesses in the education system – adds to the productivity challenge.

Excerpt of country-specific findings on Italy, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Italy was experiencing macroeconomic imbalances, in particular as regards developments related to its export performance and underlying loss of competitiveness as well as high general government sector indebtedness. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the risks involved in the persistence of imbalances. To this end, this In-Depth Review (IDR) provides an economic analysis of the Italian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings from this analysis are:

- **Persistently dismal growth exacerbates the Italy's macroeconomic imbalances and reform efforts so far appear to be insufficient.** Over the last fifteen years, economic growth in Italy has been weaker than in the rest of the euro area, primarily because of sluggish productivity growth. The crisis has aggravated the country's structural weaknesses, while growth prospects remain unfavourable and social and regional divides are increasing. Reform efforts so far appear to be insufficient to re-launch productivity growth, also due to inadequate implementation and, at times, inconsistent policy strategies. Italy's poor productivity performance is at the root of the country's declining external competitiveness and weighs on the sustainability of its high public debt.
- **The very high government debt remains a heavy burden for the Italian economy and a major source of vulnerability, especially in a context of protracted weak growth.** Under strong financial-market pressure, Italy undertook a significant fiscal adjustment effort between 2011 and 2013 that averted immediate sustainability risks. In addition, past pension reforms – once fully implemented – will have a beneficial effect on the medium-to-long-term sustainability of Italy's public finances. However, stylised simulations up to 2020 show that high primary surpluses and sustained nominal growth are both necessary to put the debt ratio on a satisfactory declining path. Meeting these conditions requires continued fiscal discipline and decisive structural reforms to boost productivity and competitiveness.
- **The correction of Italy's current account balance is mostly driven by falling imports while export competitiveness has not improved.** In 2013, the Italian current account balance returned to surplus. Its sharp correction since mid-2011 is mainly due to falling domestic demand. While the risk of an immediate return to pre-crisis current account deficits is limited, Italy's export competitiveness remains weak, as reflected by the continued erosion of its export market shares, in particular vis-à-vis euro-area trade partners.
- **Wage dynamics not aligned with productivity developments weigh on cost competitiveness, while non-cost factors remain unfavourable.** Italy's unit labour costs have been rising relative to trade partners since the beginning of the 2000s. There are signs that nominal wages are adjusting, mainly because of a freeze in public sector wages. However, collective bargaining remains highly centralised at the sectoral level and largely unresponsive to firm-level productivity and local labour market conditions. Furthermore, a high tax wedge weighs on the cost of labour. Cost pressures also stem from the country's heavy reliance on imported energy and the high cost of doing business. Finally, Italy's competitiveness is hampered by an unfavourable product specialisation and a high share of small firms with a weak competitive position in international markets.
- **Long-standing structural weaknesses distort the allocation of labour and capital, hold back innovation and technology absorption and hamper the beneficial impact of reforms already taken.** Despite progress in improving labour and product markets regulation, remaining barriers to competition, inefficiencies in the public administration and judicial system and governance weaknesses hinder the reallocation of resources towards productive firms and sectors. The insufficient development of capital markets holds back technology absorption and innovation further. These

factors also limit the inflow of foreign direct investment into Italy and hamper the impact of reforms on the ground.

- **Italy's human capital accumulation is failing to adapt to the needs of a modern competitive economy.** Italy has the fourth highest share of population with only basic education and the lowest share with tertiary education in the EU. Labour market segmentation, a difficult transition from education to work as well as a wage structure which favours old incumbents signal that the burden of slow growth and adjustment largely falls on the younger cohorts and result in low returns to education compared to the rest of the EU. Structural weaknesses in the education system, including high drop-out rates during early years of both the secondary and tertiary level, as well as low participation in life-long learning programmes, further contribute to Italy's skill gap. The economy's high share of low-to-medium technology sectors is both a further driver and an outcome of these developments.
- **The crisis has eroded the initial resilience of the Italian banking sector and has weakened its capacity to support the economic recovery.** The protracted recession is taking its toll on Italian banks' balance sheets through a strong increase in non-performing corporate loans, which weigh on profitability. Credit supply conditions, especially for (small) firms, remain tight. The increased exposure to the domestic sovereign has made banks more vulnerable to public finance developments. Despite a gradually improving liquidity situation, Italian banks remain to a large extent dependent on Eurosystem funding. Overall, the sector has strengthened its capital position in recent years, but second-tier medium-sized institutions appear weaker than the rest of the sector.
- **Italy's macroeconomic imbalances have negative spillover effects on the euro area as a whole.** Italy's GDP accounts for around 16.5% of euro-area GDP. Its slow growth acts as a drag on the recovery of the euro area as a whole. Furthermore, the country's high debt could impact the euro area by affecting financial market sentiment and confidence. At the same time – within the context of the monetary union – low demand and low inflation in the rest of the euro area make Italy's adjustment more difficult.

The IDR also discusses the policy challenges stemming from these imbalances and possible avenues for the way forward. A number of elements can be considered:

- **Italy has for too long postponed much-needed structural reforms.** The lack of reform in the past and the size of the policy challenges facing the Italian economy have made it all the more urgent to fully and effectively implement the measures already adopted and decisively step up the pace of reforms, while ensuring a fair distribution of the burden of adjustment. The decline in financial-market pressures in recent months and the gradual improvement of the economic outlook represent a precious window of opportunity in this respect.
- **Robust productivity-enhancing reforms would help to ensure a sustainable recovery and unleash Italy's growth potential.** Policy actions could include: addressing long-standing inefficiencies in the public administration and judicial system, fostering the modernisation of corporate governance practices in the public and private sector, fighting corruption and the shadow economy, and removing the remaining barriers to competition in product markets. Addressing hindrances to human capital accumulation, both in the education system and in the labour market, would significantly enhance Italy's growth prospects. Reigniting the flow of credit to the real economy and further developing capital markets would ensure adequate financing to innovative activities. Finally, enabling existing pockets of export strength to increase their weight in the overall economy and fostering the creation and growth of innovative firms, in particular by removing impediments to the reallocation of resources to more productive tradable sectors, would help to create the conditions for dynamic and sustainable growth.

- **Reducing the high government debt at a satisfactory pace requires sustained fiscal discipline.** Reaching the medium-term objective (MTO) of a structurally balanced budget and achieving and maintaining sizeable primary surpluses for an extended period of time are essential to put Italy's high government debt-to-GDP ratio on a steadily declining path, while preserving investor confidence. Sustained fiscal discipline needs to be supported by growth-enhancing strategies.
- **As productivity-enhancing measures take time to bear fruit, levers to address cost pressures in the economy could be explored.** Maintaining labour cost moderation and overcoming rigidities in wage-setting to allow wage differentiation would help Italy to regain cost competitiveness in the short run. Wage differentiation, which accounts for the large disparities in productivity and labour market conditions in the economy, would also help to improve the economy's allocative efficiency and enhance productivity. Possible deflationary risks with negative consequences for private and public debt dynamics would warrant close monitoring. Decisive measures to shift the tax burden away from productive factors in a budget-neutral way would also help to support external competitiveness and make the tax system more growth-friendly. In addition, immediate action could start to address the high cost of doing business, in particular by simplifying tax compliance and administrative procedures.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its third Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in-depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up it will recommend to the Council.

This is the third IDR for Italy. The previous IDR was published on 10 April 2013 on the basis of which the Commission concluded that Italy was experiencing macroeconomic imbalances, in particular as regards developments related to its export performance and underlying loss of competitiveness as well as high general government indebtedness. Overall, in the AMR the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the risks involved in the persistence of imbalances. To this end this IDR provides an economic analysis of the Italian economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

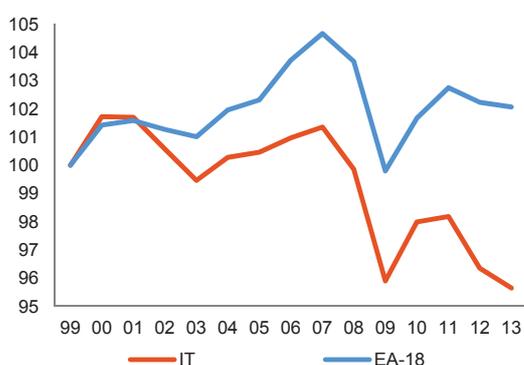
2. MACROECONOMIC DEVELOPMENTS

Growth performance and inflation outlook

Italy's growth performance has been persistently weak in comparison to its euro-area partners. Between 1999 and 2007, Italy's annual real GDP growth averaged 1.6%, significantly lower than the euro-area average of 2.2%. The main reason for Italy's weak growth performance was stagnant total factor productivity (TFP) (Graph 2.1), while investment increased at a similar pace as in the rest of the euro area (see also Section 3.3).

The crisis exacerbated Italy's growth gap. Italy's output loss during the crisis – driven by a strong decline in investment – has exceeded that of most of its euro-area peers (Graph 2.2). Between 2007 and 2013, Italy's real GDP contracted by 8.7% compared to a fall of 1.7% for the euro area as a whole. After the sharp contraction in 2008-09, the economy rebounded in 2010, but entered a second recession in the second half of 2011. Real GDP contracted by 2.5% in 2012 and a further fall of 1.9% was recorded in 2013, based on quarterly data.

Graph 2.1: Evolution of total factor productivity (1999 = 100)



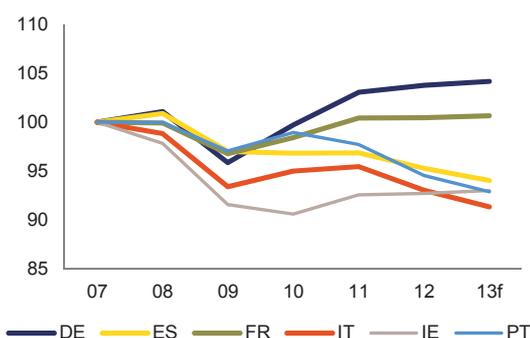
Source: Commission services

Growth prospects remain unfavourable in the short term. The Commission 2014 Winter Forecast⁽¹⁾ ("Commission Forecast" hereafter) projects a slow recovery, lifting real GDP by 0.6% in 2014. Economic activity is expected to be primarily supported by exports which will in turn foster investment. In 2015, growth is expected to accelerate to 1.2% as financing conditions are projected to ease and external demand continues to

⁽¹⁾ European Commission (2014d)

support exports. However, potential growth is estimated to be flat over 2014-15, with labour and capital accumulation as well as TFP providing no contribution.

Graph 2.2: Evolution of real GDP (2007 = 100)



Source: Commission services

The crisis triggered a sharp reversal of private foreign capital flows into Italy and a related strong current account adjustment. In the second half of 2011, private capital flows from abroad dried up given widespread risk aversion vis-à-vis Italy and other vulnerable euro-area countries following the sovereign debt crisis. This was associated with a sharp correction of the current account balance which turned positive in the course of 2013. The Commission Forecast projects the current account balance to stabilise at a surplus slightly above 1% of GDP in 2014-15.

Inflation is set to remain very moderate over the forecast horizon. Limited labour cost pressures combined with weak consumption and stable energy prices lead the Commission Forecast for HICP-based inflation to fall to 0.9% in 2014, and then increase to 1.3% in 2015 as the economic recovery strengthens.

Public finance developments

The medium-term objective (MTO) of a balanced budgetary position in structural terms has not been achieved yet. Rapidly rising sovereign bond yields forced the Italian authorities to undertake a fast fiscal consolidation, which enabled Italy to reduce its headline public deficit from 5.5% of GDP in 2009 to 3% in 2012 and exit the excessive deficit procedure (EDP) in June 2013. In the same period, the structural primary balance improved even more, i.e. by more than 3.5

pps. of GDP. The fiscal adjustment affected both the expenditure and the revenue sides. On the expenditure side, public wages have been frozen since 2011 and new recruitment has been significantly reduced, while indexation of higher pensions to inflation has been frozen and the retirement age has been raised. On the revenue side, the standard VAT rate was raised in two steps from 20% to 22%. In addition, taxation of households' financial wealth and especially immovable property has been increased. After stabilising at 3% of GDP in 2013, the Commission Forecast projects the government deficit to fall to 2.6% in 2014 and 2.2% in 2015, in the absence of policy changes. The structural balance is estimated to have further improved in 2013 (to -0.8% of GDP from -1.4% in 2012). A marginal improvement (to -0.6% of GDP) is also expected in 2014, while the structural balance is set to worsen in 2015 under a no-policy-change assumption. The structural primary surplus is expected to remain stable at around 4.5% of GDP over 2013-15.

Italy's general government debt-to-GDP ratio has increased. In spite of fiscal consolidation, Italy's public debt-to-GDP ratio rose from 103.3% in 2007 to just below 133% in 2013, driven by a combination of negative real growth and continued fiscal deficits, as well as financial support to euro-area programme countries and the settlement of government trade debt arrears (for an amount of around 3.6% and 1.4% of GDP respectively). After incorporating the effects of the further settlement of trade debt arrears (1.6% of GDP) and privatisation proceeds (0.5% of GDP), the general government debt ratio is set to peak in 2014 (at 133.7% of GDP) and then decline slightly in 2015 thanks to the projected higher primary surplus and nominal GDP growth.

Financing conditions

Italian firms have been negatively affected by the protracted economic downturn and high corporate bank lending rates hamper economic recovery. The double-dip recession and the increased lending rates following sovereign risk premium developments have put pressure on Italian firms' profitability. Although Italian non-financial firms' indebtedness as a share of GDP is below the euro-area average, their leverage is rather high, especially due to a debt bias in their

funding. At the end of 2013, the average interest rate on a new corporate loan was respectively 128 and 110 basis points higher than in Germany and France. Small firms in Italy faced a lending rate which on average was 207 basis points higher than for large Italian firms. Tight supply conditions, combined with subdued loan demand, have led to a strong contraction of credit to firms (Graph 2.3). Box 2.1 discusses the general state of the Italian banking sector and its role within the economy more widely.

Graph 2.3: 12-month % change in loans from monetary and financial institutions (MFIs) to Italian firms



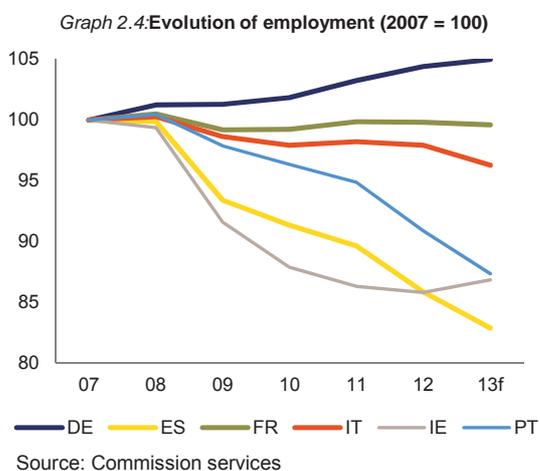
Source: Bank of Italy

Employment and social conditions

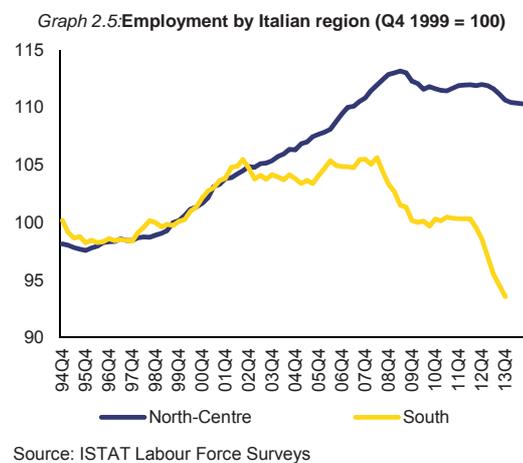
The long and deep recession has dampened employment prospects. Employment in Italy did not fall as much as in other vulnerable euro-area countries (Graph 2.4), but the already wide regional disparities increased further, with the South of the country absorbing most of the decline (Graph 2.5). Italy's unemployment rate doubled from 6.1% in 2007 to 12.2% in 2013, while remaining lower than in Spain and Portugal. At the same time, there has been a sharp reduction in the number of hours worked per employee, largely owing to the massive use of the wage supplementation scheme between 2008 and 2013, but also the steady increase in the number of part-time workers to nearly 18% of total employment in 2013. In particular, the share of involuntary part-time workers rose from around 40% at the onset of the crisis to nearly 62% in 2013.⁽²⁾ These developments helped to contain the rise in

⁽²⁾ Involuntary part-time workers are persons aged 15-74 working part-time but wishing and being available to work more hours.

unemployment but may also have slowed down the reallocation of resources and indicates that labour market distress in Italy during the crisis increased more than when measured only by unemployment figures. The number of persons available for work but not actively seeking it – commonly referred to as 'discouraged workers' and not considered as unemployed – also increased substantially during the crisis. This implies that a wider measure of under-employment (including both 'discouraged workers' and 'involuntary part-time workers') went up to about one fourth of the labour force. It must be noted that the measure of 'discouraged workers' has always been higher in Italy than in other countries, and may hide undeclared workers. The younger generations have been particularly affected by the crisis: in 2013, the youth (aged 15-24) unemployment rate was 40%, while around one in five youngsters was reported not to be in employment, education or training. The Commission Forecast expect a further rise in the unemployment rate in 2014 and a marginal decline in 2015, as the recovery is slow and improves employment prospects with some lag.



Social hardship has increased. Between 2008 and 2012, Italy recorded the fourth largest increase in the EU in the share of people at risk of poverty or social exclusion (AROPE), which rose from 26% in 2007 to around 30% in 2012. Regional disparities matter: AROPE scores are significantly higher in southern regions than in Italy as a whole. In addition, poverty entry and exit rates are respectively high and low, indicating the presence of poverty traps.



Reforms and implementation

The Italian authorities have adopted several measures to respond to the crisis and enhance potential growth. In 2011-12, Italy has adopted important structural reforms alongside the considerable fiscal consolidation efforts. The labour market reform (see Box 3.2) and especially the pension reform were the most important actions taken. Other relevant measures concerned the reform of the recurrent taxation on property, the introduction of an allowance for corporate equity (ACE, which was recently further strengthened), action in the area of civil justice as well as the liberalisation of professional services and energy sector.

The pace of reforms is slow and their impact has been reduced by sluggish implementation. More recently, other measures of more limited ambition have been taken in various areas. Some simplification and market opening measures (particularly in network industries) are positive steps to build a more growth-friendly business environment, but only limited action has been taken to support further market opening in the services sectors. Taxation has somewhat shifted away from labour and there has been a reform of the tax deductibility of banks' loan loss provisions, but the announced revision of cadastral values and the reduction of tax expenditures have not been implemented yet. On education, recent efforts are limited with respect to the challenge that Italy faces regarding human capital (see Section 3.3). There are also delays in implementing the system for the evaluation of schools. Decisive action to improve the effectiveness of the public

administration is lagging behind. This in turn weighs on the effective implementation of new reform initiatives, in particular because of insufficient coordination between government layers.

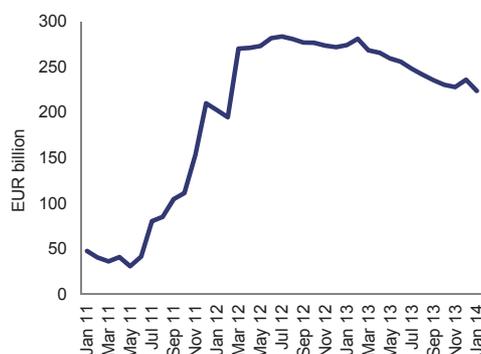
Box 2.1: Developments in the Italian banking sector

The crisis has eroded the initial resilience of the Italian banking sector and led to an increase in the reliance on the Eurosystem.

Italian banks weathered the first phase of the global financial crisis in 2008-09 relatively well. In the course of 2011 however, they started to lose access to international wholesale funding in the context of a negative feedback loop between fiscal sustainability concerns, banks' domestic sovereign exposure and weak growth prospects which undermined investor confidence. The impaired wholesale market access was addressed through Italian banks' large participation in the Eurosystem's two 3-year long-term refinancing operations (LTROs) in December 2011 and February 2012. Although banks' funding situation has been gradually improving since mid-2012 – also thanks to steady resident deposit growth – in January 2014, the sector's dependence on the Eurosystem still amounted to EUR 224 billion (down by 21% from the peak in July 2012), equal to a third of total outstanding Eurosystem funding (Graph 1). Over the first 10 months of 2013, Italian banks – in particular the two largest groups – placed a modest EUR 27 billion in secured and unsecured bonds on international wholesale markets (up from EUR 18 billion in 2012) – with the cost of funding having fallen compared to 2012 – but redemptions still exceeded gross issues. ⁽¹⁾

Several years of recession have put strain on the balance sheets of Italian banks and on their capacity to support the recovery of the domestic economy. The strong increase in credit risk – especially on corporate exposures – has led to a sharp rise in non-performing loans (NPLs) and lower coverage ratios compared to pre-crisis levels. In combination with contracting credit, this rise in non-performing exposures has led to the tripling of the ratio of NPLs to total customer loans from 5.1% at the end of 2008 to 16% at the end of

Graph 1: Italian banks' reliance on Eurosystem funding



Source: Bank of Italy

September 2013. ⁽²⁾ The average NPL ratio of the top-5 banking groups is somewhat higher than that of the sample of second-tier banks, but the latter have a lower NPL coverage ratio (Table 1). ⁽³⁾ The stock of bad debts ⁽⁴⁾ amounted to EUR 156 billion at end-2013 and is mainly concentrated with firms, in particular those active in construction, real estate and wholesale and retail trade. The ratio of corporate bad debts to total corporate loans has increased from 3.6% in January 2008 to 12.6% in November 2013, while that for producer households has risen from 7% to 13.6% (Graph 2). In response to declining NPL coverage, the Bank of Italy conducted a targeted asset quality review in 2012-13, while an increase in the tax deductibility of loan-loss provisions was announced as part of the 2014 Stability Law. Meanwhile, the strong increase in loan-loss provisions for impaired loans – in combination

⁽²⁾ Non-performing loans include four categories: bad debts, substandard loans, restructured exposures and past-due/overdrawn exposures. International comparisons of NPL ratios involving Italy should take account of the fact that impaired loan classification criteria in Italy are stricter than in most other countries. The high stock of NPLs in Italy vis-à-vis other countries is also influenced by lengthy credit recovery procedures.

⁽³⁾ For Italian banking groups active abroad, there is also a marked difference between the asset quality of their domestic and foreign loan portfolios.

⁽⁴⁾ Bad debts ('sofferenze') constitute the worst category of impaired loans on Italian banks' balance sheets and include on- and off-balance sheet exposures to borrowers in a state of insolvency or in a similar situation.

⁽¹⁾ Bank of Italy (2013b)

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Box (continued)

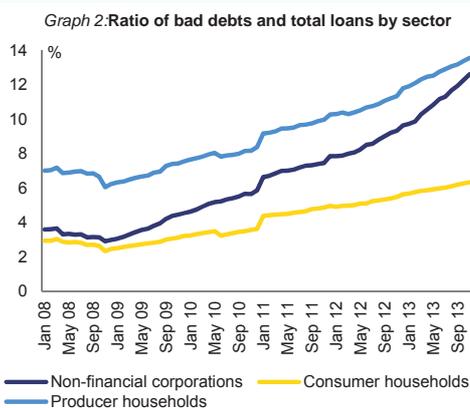
with contracting net interest income – is weighing heavily on profitability. The annualised return-on-equity of the 34 largest Italian banking groups over the first half of 2013 was 1.2%, compared to 1.9% over the same period in 2012. The weak profitability outlook, high credit risk, relatively elevated bank funding costs owing to continued financial market fragmentation in the euro area and the phase-in of stricter capital rules under the EU's Capital Requirements Regulation and Directive (CRR/CRD) are all likely to contribute to continued tight credit supply conditions in the short term, thereby hindering the recovery of the Italian economy. In the long term, sound and resilient banks should foster economic recovery.

Table 1:
Key financial soundness indicators for the top-15 Italian banking groups, June 2013

	Top 5 banks	Top 6-15 banks
Core tier-1 capital ratio (%)	11.2	8.6
Funding gap (%)	16.6	10.4
Overall NPL ratio (%)	15.3	12.8
<i>(of which)</i>		
Bad debts	8.5	6.3
Substandard	4.6	4.6
Restructured	1.2	0.6
Past-due	1	1.3
NPL stock (EUR bn)	197	60
Coverage ratio (%)	41.0	35.4

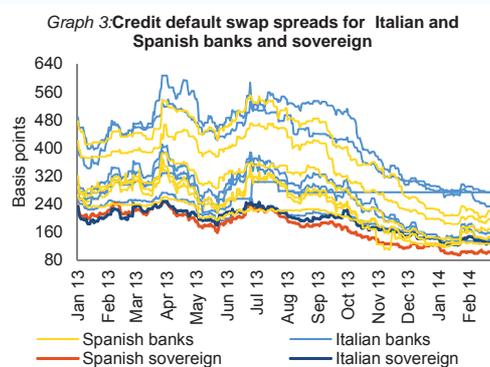
Source: Bank of Italy

Note: The funding gap is the share of loans not financed by retail funding. NPL ratios are relative to total customer loans. NPL coverage ratios are relative to NPL gross exposure.



Credit default swap (CDS) spreads for Italian banks have recently declined. The gradual improvement of market sentiment has

led to a decline in CDS spreads for Italian banks and the Italian sovereign, which have been closely linked during the crisis (Graph 3). CDS spreads for Spanish banks however have fallen to even lower levels and their dispersion has diminished. This is likely the result of the balance sheet clean-up which has taken place in the Spanish banking sector, whereas progress in this field in the Italian banking sector has been more limited so far.



The top-5 Italian banking groups exhibit stronger capital ratios than the second tier of medium-sized banks. In spite of the crisis context, capital adequacy at system level has strengthened over the last couple of years. However, the relatively strong position of the top-5 Italian banking groups included in the ECB's comprehensive assessment of the euro-area banking sector contrasts somewhat with the weaker position of the top 6-15 (medium-sized second-tier banks) that also participate in the ECB's review.⁽⁵⁾ According to Bank of Italy (2013b), the average core tier-1 ratio of the top-5 groups stood at 11.2% in June 2013, compared to 8.6% for the group of second-tier banks (Table 1). Recent stress tests by the IMF and the Bank of Italy have however shown that the Italian banking system as a whole is

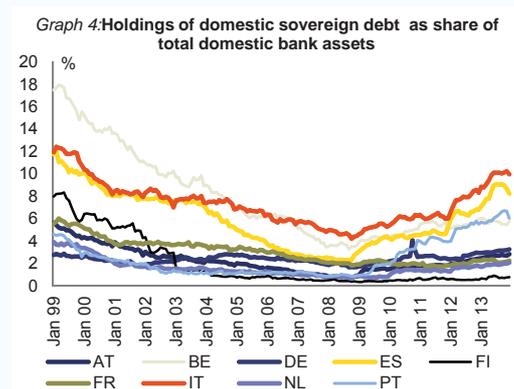
⁽⁵⁾ In June 2013, the collective market share of the top-5 Italian banking groups – as proxied by the share of total customer loans – amounted to 62.6%, whereas that of the top 6-15 banks was 22.5%.

(Continued on the next page)

Box (continued)

sufficiently capitalised to withstand both baseline and adverse economic scenarios. ⁽⁶⁾

During the euro-area sovereign debt crisis, domestic banks' exposure to the Italian sovereign has increased significantly. Italian banks traditionally hold substantial amounts of domestic sovereign debt, taking advantage of the very liquid market. In the second half of 2011, foreign investors significantly reduced their exposure to Italian sovereign debt due to increased risk aversion. Between January 2010 and November 2013, the stock of Italian government securities held by Italian banks rose from EUR 211 billion to EUR 416 billion. This corresponds respectively to 5.4 % and 10.2 % of total Italian bank assets, one of the highest shares in the euro area (Graph 4). Banks have engaged in carry trade ⁽⁷⁾ which on the back of the low cost of LTRO funding has significantly supported the profitability of several institutions. Since mid-2013, Italian banks' exposure to domestic sovereign bonds has stabilised. The approaching deadline for reimbursing LTRO funds, the recent decline in sovereign yields, and the EU's new CRR/CRD may discourage the further acquisition of government securities.



Source: European Central Bank

The direct exposure of the Italian financial system to domestic government debt makes banks vulnerable to adverse developments

⁽⁶⁾ IMF (2013a), Bank of Italy (2013b)

⁽⁷⁾ Carry trade exploits the positive spread between the (high) yield on (domestic) sovereign bonds and the (low) refinancing rate offered on the Eurosystem's 3-year LTROs.

in Italy's sovereign risk. Despite the recent decrease in Italian sovereign yields, the strong rise in Italian banks' holdings of domestic government debt has increased the vulnerability of the banking sector to renewed adverse sovereign yield and credit rating developments through various channels: (i) the adverse influence of higher sovereign yields on bank funding costs; (ii) the negative effect on profitability from mark-to-market losses on sovereign debt holdings in some of the banks' trading portfolios; (iii) the negative effect on the availability and valuation of collateral, required in particular for Eurosystem refinancing. Beyond balance sheet exposure, the Italian banking sector is also indirectly exposed to the domestic sovereign through the effect of the latter's high indebtedness on the real economy (see Section 3.1).

The Italian banking sector is still characterised by a number of structural weaknesses. The modest performance of the Italian banking sector in terms of operational cost efficiency, mainly related to the fragmentation of the sector in many small banks and the high density of the Italy's bank branch network, in combination with the current environment of low profitability and weak growth prospects represents a particular vulnerability to the sector. Italy's largest and internationally active banking groups however exhibit higher cost efficiency than smaller institutions and perform at broadly the same level as the largest banks in some other European countries. Furthermore, some corporate governance features, like restrictions on share ownership and voting rights at mutual and cooperative banks might make it difficult to raise new capital when needed. In addition, the persistent but opaque influence of foundations – non-profit entities characterised by strong ties with local business and politics – may no longer be optimal. These findings are relevant as IMF (2013a) in its recent stress test identified banks with a significant presence of banking foundations among their shareholders, in addition to cooperative banks, as the weakest links of the Italian banking system.

Table 2.1:

Key economic, financial and social indicators - Italy	2007	2008	2009	2010	2011	2012	Forecast		
							2013	2014	2015
Real GDP (yoy)	1.7	-1.2	-5.5	1.7	0.5	-2.5	-1.9	0.6	1.2
Private consumption (yoy)	1.1	-0.8	-1.6	1.5	-0.3	-4.1	-2.5	0.1	0.9
Public consumption (yoy)	1.0	0.6	0.8	-0.4	-1.2	-2.7	-0.6	-0.6	0.4
Gross fixed capital formation (yoy)	1.8	-3.7	-11.7	0.6	-2.2	-8.3	-5.5	1.6	3.7
Exports of goods and services (yoy)	6.2	-2.8	-17.5	11.4	6.2	2.0	0.1	3.3	4.9
Imports of goods and services (yoy)	5.2	-3.0	-13.4	12.6	0.8	-7.4	-2.9	3.0	5.5
Output gap	3.3	1.8	-3.5	-1.7	-1.4	-3.0	-4.3	-3.6	-2.4
Contribution to GDP growth:									
Domestic demand (yoy)	1.2	-1.1	-3.2	0.9	-0.8	-4.6	-2.6	0.3	1.3
Inventories (yoy)	0.2	0.0	-1.2	1.1	-0.1	-0.7	-0.1	0.1	0.0
Net exports (yoy)	0.2	0.0	-1.1	-0.4	1.4	2.8	0.9	0.2	0.0
Current account balance BoP (% of GDP)	-1.3	-2.9	-2.0	-3.5	-3.1	-0.4	.	.	.
Trade balance (% of GDP), BoP	-0.3	-0.7	-0.5	-1.9	-1.5	1.1	.	.	.
Terms of trade of goods and services (yoy)	1.1	-2.1	5.7	-3.7	-2.9	-1.1	1.8	1.0	0.0
Net international investment position (% of GDP)	-24.5	-24.1	-25.3	-23.9	-21.7	-26.4	.	.	.
Net external debt (% of GDP)	41.4	40.6	45.2	51.8	50.1	56.6	.	.	.
Gross external debt (% of GDP)	113.2	107.7	116.1	117.9	115.5	121.7	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	8.9	8.5	7.1	4.9	4.3	3.6	.	.	.
Private credit flow (consolidated, % of GDP)	12.4	6.9	1.6	4.7	3.1	-0.9	.	.	.
Private sector debt, consolidated (% of GDP)	114.4	118.7	125.3	126.3	125.8	126.4	.	.	.
Deflated house price index (yoy)	2.7	-0.4	-0.4	-2.2	-2.1	-5.4	.	.	.
Residential investment (% of GDP)	5.8	5.8	5.6	5.6	5.3	5.1	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	0.5	-2.7	5.7	1.6	3.9	7.1	.	.	.
Tier 1 ratio (1)	6.9	6.9	8.3	8.8	9.6	10.7	.	.	.
Overall solvency ratio (2)	9.9	10.4	11.6	12.1	12.7	13.4	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	4.4	5.0	7.5	8.4	9.5	11.0	.	.	.
Employment, persons (yoy)	1.2	0.2	-1.7	-0.7	0.3	-0.2	-2.0	-0.2	0.5
Unemployment rate	6.1	6.7	7.8	8.4	8.4	10.7	12.2	12.6	12.4
Long-term unemployment rate (% of active population)	2.9	3.1	3.5	4.1	4.4	5.7	.	.	.
Youth unemployment rate (% of active population in the same age group)	20.3	21.3	25.4	27.8	29.1	35.3	.	.	.
Activity rate (15-64 years)	62.5	63.0	62.4	62.2	62.2	63.7	.	.	.
Young people not in employment, education or training (% of total population)	16.2	16.6	17.7	19.1	19.8	21.1	.	.	.
People at-risk poverty or social exclusion (% total population)	26.0	25.3	24.7	24.5	28.2	29.9	.	.	.
At-risk poverty rate (% of total population)	19.8	18.7	18.4	18.2	19.6	19.4	.	.	.
Severe material deprivation rate (% of total population)	6.8	7.5	7.0	6.9	11.2	14.5	.	.	.
Persons living in households with very low work intensity (% of total population)	10.0	9.8	8.8	10.2	10.4	10.3	.	.	.
GDP deflator (yoy)	2.4	2.5	2.1	0.4	1.4	1.7	1.3	1.1	1.4
Harmonised index of consumer prices (yoy)	2.0	3.5	0.8	1.6	2.9	3.3	1.3	0.9	1.3
Nominal compensation per employee (yoy)	2.3	3.8	1.7	2.8	1.3	1.0	1.3	1.1	1.5
Labour Productivity (real, person employed, yoy)	0.4	-1.4	-3.9	2.5	0.2	-2.2	.	.	.
Unit labour costs (whole economy, yoy)	1.5	4.7	4.6	0.0	1.0	2.5	1.3	0.7	0.8
Real unit labour costs (yoy)	-0.8	2.1	2.4	-0.4	-0.4	0.8	0.0	-0.4	-0.6
REER (ULC, yoy)	1.0	2.6	1.8	-2.9	0.5	-1.6	3.0	1.4	-0.4
REER (HICP, yoy)	0.9	1.4	1.3	-4.5	0.0	-1.8	1.8	1.1	-0.6
General government balance (% of GDP)	-1.6	-2.7	-5.5	-4.5	-3.8	-3.0	-3.0	-2.6	-2.2
Structural budget balance (% of GDP)	-3.6	-3.9	-4.2	-3.7	-3.8	-1.4	-0.8	-0.6	-0.8
General government gross debt (% of GDP)	103.3	106.1	116.4	119.3	120.7	127.0	132.7	133.7	132.4
(1) Domestic banking groups and stand-alone banks									
(2) Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches									
Source: Commission services, European Central Bank									

3. IMBALANCES AND RISKS

Stagnating productivity is at the root of Italy's loss of external competitiveness and weighs on the sustainability of the high public debt.

Simultaneously reducing public indebtedness and improving external competitiveness is very challenging because, while nominal wage moderation could help to recover cost competitiveness in the short term, it would weigh on the country's debt dynamics.⁽³⁾ Hence, a durable correction of Italy's imbalances and an increase in the overall resilience of the economy critically depends on the evolution of productivity growth. Boosting productivity growth, however, requires tackling inefficiencies in the allocation of both labour and capital, while addressing insufficient human capital accumulation. This however can only happen in the longer term, which is why decisive policy action is required.

3.1. HIGH PUBLIC INDEBTEDNESS

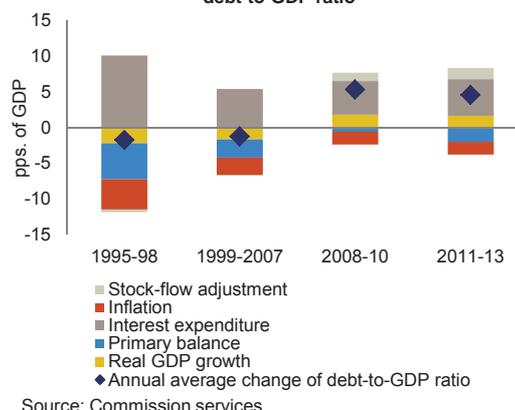
High public debt is a major source of vulnerability for the Italian economy.

The very high government debt holds back economic growth through several channels, especially because its growth has not financed a correspondingly elevated accumulation of human and physical capital endowments. A first channel is the present and expected future high level of taxation needed to service debt which dampens domestic demand and comes with distortionary costs. In particular, the heavy taxation of labour and capital in Italy weighs significantly on growth. Second, Italy's high interest expenditure – 5.3% of GDP in 2013 – limits the room for productive public expenditure. Third, high public debt limits the government's fiscal space to respond to economic shocks. Fourth, high government indebtedness makes Italy more vulnerable to sudden increases in sovereign yields and financial-market volatility, which in turn affect the real economy. Finally, large annual sovereign debt roll-over needs – in the order of 25% of GDP – expose Italy to substantial refinancing risk, in particular in periods of increased risk aversion.

Fiscal policy complacency after euro adoption contributed to a weak starting position of Italian public finances at the beginning of the

crisis. Italy undertook a major fiscal consolidation in the run-up to euro adoption: high primary surpluses drove most of the decline in the public debt-to-GDP ratio. After the introduction of the euro however, Italy benefitted from considerably lower interest expenditure, but did not maintain the large primary surplus needed to reduce the debt-to-GDP ratio at a satisfactory pace. Moreover, the beneficial effect of real GDP growth was rather small (Graph 3.1). As a result, over the period 1999-2007, Italy's public debt ratio declined by only 11 pps. to 103.3% of GDP at end-2007 from 114.3% at end-1998.⁽⁴⁾ Since the start of the crisis, the debt ratio has been steadily increasing. During the first phase (2008-10), the increase in the debt ratio was driven by negative real GDP growth and the erosion of primary surpluses. In the second phase (2011-13), interest expenditure increased owing to the higher risk premium, while real GDP continued to contract. At the same time, Italy's contribution to the financial assistance to euro-area programme countries and the settlement of government trade debt arrears – both captured by stock-flow adjustments – raised the debt ratio further (by around 3.6% and 1.4% of GDP respectively). However, higher primary surpluses – as a result of rapid fiscal consolidation in response to sovereign debt market turmoil – curbed somewhat the increase in the debt ratio, which is estimated to be just below 133% of GDP at end-2013.

Graph 3.1: Decomposition of the changes in Italy's public debt-to-GDP ratio



⁽³⁾ See for instance Fisher (1933) and Darvas (2013)

⁽⁴⁾ In comparison, Belgium managed to reduce its debt ratio by 33.2 pps. to 84% of GDP in 2007 from 117.2% in 1998, mainly thanks to a primary surplus averaging 5% of GDP during the same 1999-2007 period (2.6% in Italy).

Box 3.1: Simulations of Italian public debt sustainability

Starting from the Commission 2014 Winter Forecast up to 2015, the following stylised deterministic projections ⁽¹⁾ are run for the period 2016-20 (Graph 1):

Fiscal stance

- Primary surplus maintained at 3% GDP over the reference 2016-20 period.
- Primary surplus strengthened to 5% of GDP as of 2016, up from the structural primary surplus of 4.5% of GDP estimated for 2015. This is an ambitious policy scenario when considering that the primary surplus – peaking at 6.5% of GDP in 1997 to allow Italy to enter the euro area – averaged 2.6% of GDP over 1999-2007.

Macro outlook

- COM scenario: after incorporating the Commission 2014 Winter Forecast, real GDP growth is assumed to remain above potential growth to close the negative output gap in 2018 and then start to converge to the Ageing Working Group projections. The GDP deflator is set to gradually converge to 2% by 2018. As a result, annual nominal GDP growth is set to be slightly below 3% over 2014-20, on average.
- Extremely adverse scenario: protracted period of low real growth and inflation, resulting in an average nominal GDP growth of 1% over 2016-20.

Implicit nominal interest rate on debt

- 4%: i.e. about the implicit interest rate on Italy's government debt in 2013.

With a primary surplus at 3% of GDP, the debt-to-GDP ratio is set to remain on a downward trend if macroeconomic developments are those expected in the COM scenario. However, in this scenario, the debt-to-GDP ratio trajectory would not be sufficient to meet the Stability and Growth Pact's (SGP) debt benchmark. Under extremely adverse macroeconomic assumptions, the debt ratio is instead put on an upward path. Therefore, in case of a primary surplus at 3% of GDP, macroeconomic headwinds would represent an important risk for debt sustainability.

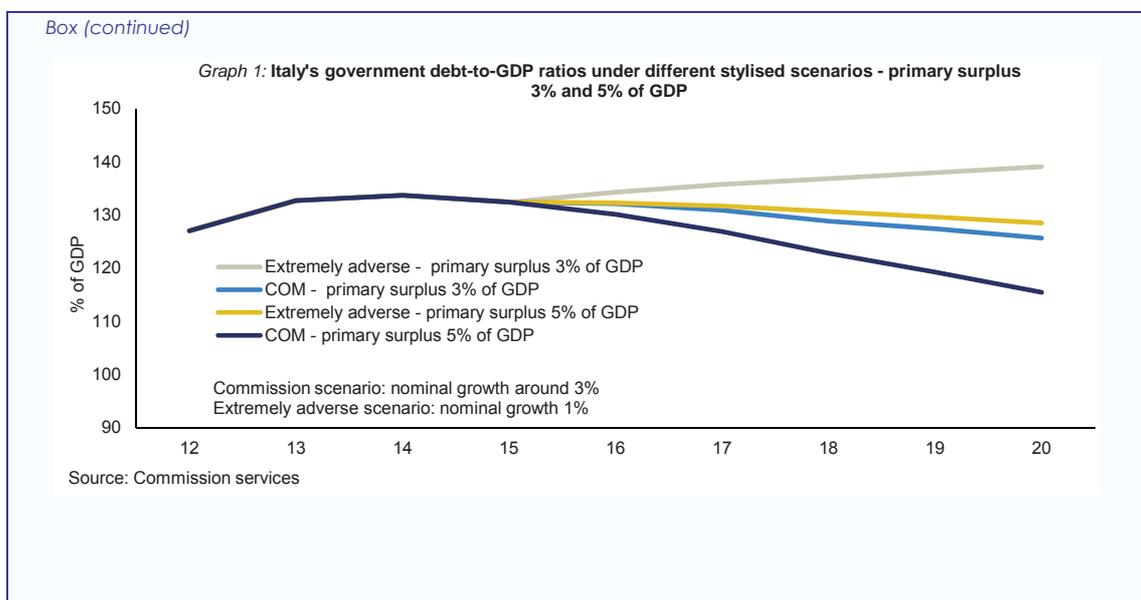
With a primary surplus at 5% of GDP, under COM macroeconomic assumptions the debt-to-GDP ratio is set on a robust downward trend, consistent with the SGP debt benchmark. In addition, such a high primary surplus would continue to ensure a broad stabilisation of the debt ratio even under extremely adverse macroeconomic assumptions. As mentioned above, past experience indicates that achieving and maintaining such a high primary surplus is challenging.⁽²⁾ Furthermore, the difficulty of maintaining an elevated primary surplus when economic activity remains subdued and deflationary pressures arise cannot be neglected.

The current structural fiscal position – if further improved and maintained – will reduce the public debt imbalance. A large primary surplus would also help preserve market confidence even if growth prospects and inflation remain weak in the short-to-medium term. However, growth and inflation have significant effects on the debt-to-GDP ratio and are important drivers of fiscal developments. Enhancing medium-to-long term growth prospects through structural reforms would greatly reduce Italy's vulnerability related to its high government debt.

⁽¹⁾ For additional and different kinds of debt projections, see for instance Berti (2013) and European Commission (2012a).

⁽²⁾ Over 1999-2007, Belgium managed to have an average primary surplus of 5% of GDP.

(Continued on the next page)



Italy's general government debt-to-GDP ratio is expected to peak at around 134% in 2014, and decline slightly in 2015 thanks to the higher primary surplus and nominal GDP growth.

Under strong financial-market pressure, the country implemented significant fiscal consolidation measures over 2011-13, which averted immediate sustainability risks thanks to the stronger fiscal position achieved (structural primary surplus estimated at around 4½ % of GDP in 2013). Italy also undertook an ambitious pension reform, which – once fully implemented – will have a beneficial effect on the medium-to-long term sustainability of public finances. These national efforts were essential to make effective the measures taken at euro-area level to strengthen the EMU's architecture and remove redenomination risk. As a result, the sovereign risk premium has substantially declined in recent months and is now close to pre-crisis levels.

Putting the government debt-to-GDP ratio on a satisfactory declining path will be a continuous challenge. Stylised simulations show that high primary surpluses and sustained growth are necessary to put the debt-to-GDP ratio on a satisfactory declining path, meeting the Stability and Growth Pact's (SGP) new debt benchmark (Box 3.1). Both conditions are challenging.

The increase in the sovereign exposure of Italian banks makes them more vulnerable to public finance developments. During the euro-

area sovereign debt crisis, domestic banks' exposure to the Italian sovereign has increased significantly (see Box 2.1). The strong rise in Italian banks' holdings of domestic government debt has supported sovereign securities after the exit of private foreign investors since mid-2011. This higher exposure has however increased the vulnerability of the banking sector to developments in sovereign yields in the absence of a complete banking union. In recent months, thanks to the stronger fiscal position achieved and the improving euro-area financial framework, yields on Italian sovereign-debt have fallen significantly and foreign private investors have been gradually returning. Finally, Italy's public debt management continues to be very effective in handling market expectations, also thanks to careful communication, and auctions have continued to be successful.

3.2. LOSS OF EXTERNAL COMPETITIVENESS

The significant loss of external competitiveness weakens Italy's growth prospects. Italy's current account has recently improved sharply, but the turn-around appears to be driven by a structural decline in potential growth and the associated weak domestic demand, rather than a recovery of Italy's export position. Despite some recent resilience in exports to non-euro-area countries, Italy continues to suffer from weakening cost competitiveness and an unfavourable product

specialisation, reflected in the country's relatively large decline in export market share, especially vis-à-vis the euro area. The overall weakening of Italy's export position does not only imply a reduced ability to exploit external demand as a source of domestic growth, but also a gradually eroding capacity to pay for imports, in particular of energy for which Italy is structurally dependent on foreign suppliers. A weakened export position could eventually lead to renewed external deficits, which would again expose Italy to the risk of a sudden reversal of foreign capital inflows.

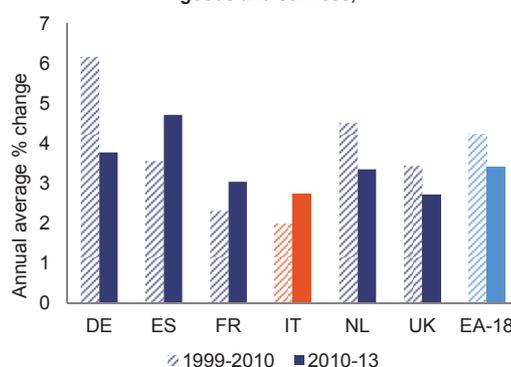
3.2.1. Export performance

Since euro adoption, Italy has been subject to significant export market share erosion. Between 1999 and 2010, the volume of Italian exports on average increased by 2% per year, significantly below the 4.2% average annual growth recorded for the euro area as a whole (Graph 3.2). This weak export performance has implied a loss of export market share, which is larger than the market share erosion recorded by other European countries (Graph 3.3).⁽⁵⁾ Since 2010, the gap between Italy's and some European peers' average annual export volume growth narrowed somewhat: over the period 2010-13, average annual growth of Italian export volumes stood at 2.7% versus a euro-area average of 3.4%. In parallel, the loss of Italian export market share in value terms stabilised in 2010 after the first phase of the global financial crisis, but the country still underperformed compared to some European peers – in particular Spain – which managed to expand their export market share.

Italy's loss of export market share was particularly acute over 2008-09. The decline of Italy's export volumes and export market share in 2008-09 was more pronounced than the one recorded by European peers. A significant part of those large market share losses were recorded vis-à-vis euro-area trade partners, and virtually no recovery took place in subsequent years. In contrast, over 2010-13, Italy's export performance

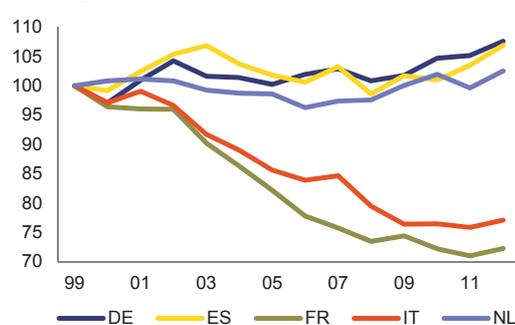
in extra-euro-area markets was particularly positive thanks to stronger demand and a relatively favourable euro exchange rate (Graph 3.4). One explanation for this diverging trend could be that larger and more productive Italian firms, which were already able to export outside the euro area, managed to catch up with growing demand from extra-euro-area markets, thereby maintaining their market shares.

Graph 3.2: Annual average % change in export volumes of goods and services,



Source: Commission services

Graph 3.3: Evolution of world export market shares in goods and services (value terms) (1999 = 100)



Source: Commission services

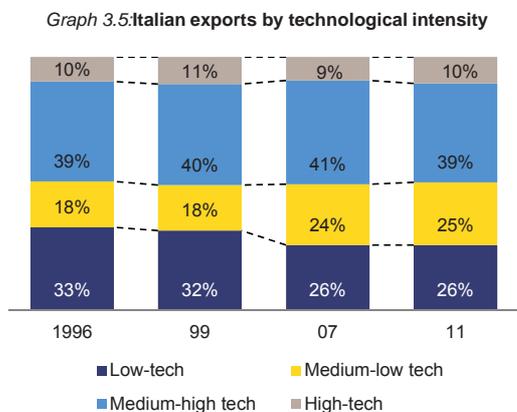
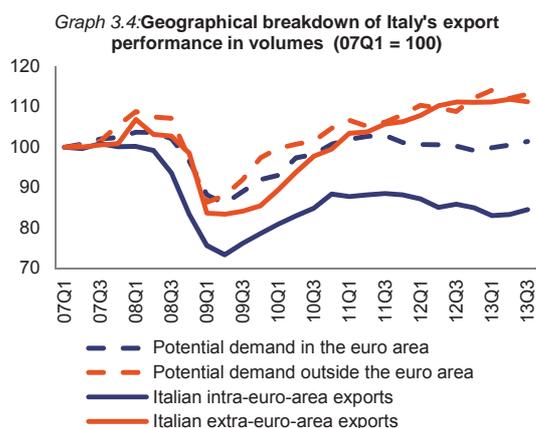
Note: Considering 36 industrial markets.

The still large share of low and medium-low technology exports exposes the country to strong cost competition. Although Italy's sectoral composition of exports has undergone some changes – notably a modest shift from low-tech to medium-low tech goods (Graph 3.5) – it is still biased towards traditional sectors such as textiles, leather products and footwear, in addition to scale-driven industries such as basic metals, foodstuffs, plastics, stone, ceramics, cement and glass.⁽⁶⁾

⁽⁵⁾ Italy's loss of export market share expressed in value terms is slightly smaller than when expressed in volume terms. Part of this difference might be due to a relatively strong increase in Italy's export unit values, which may indicate that Italian firms have to some extent been focusing on climbing the quality ladder. See for instance European Commission (2012b) and IMF (2013b).

⁽⁶⁾ See for instance IMF (2013b).

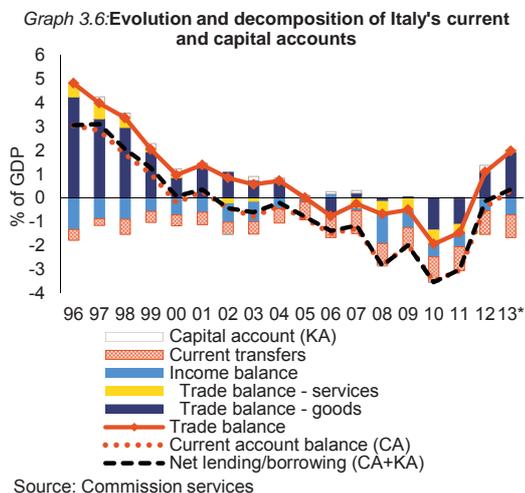
With the liberalisation of global trade, this export product mix has increasingly exposed Italy to strong cost competition. Some Italian exporters might have been able to maintain their market share by focusing on quality and on product and process innovation, but the scale of this adjustment process remained insufficient to offset the decline recorded by exporters in other sectors.



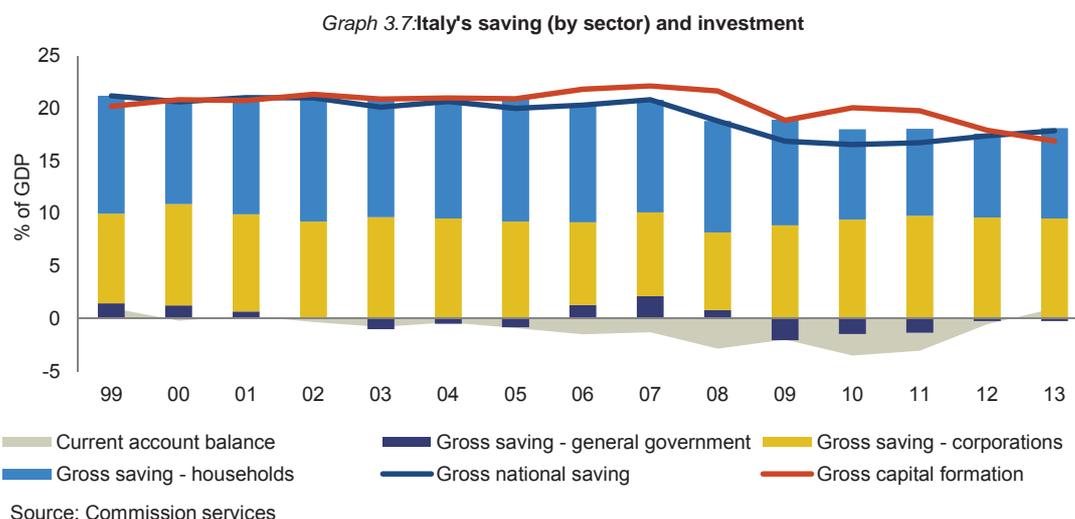
3.2.2. Developments in current and financial accounts and net external position

Since mid-2011, Italy's current account balance has corrected sharply and is now again in surplus, mainly due to a strong decline in imports. Most of the correction in the current account took place between 2011 and 2012, when net external borrowing improved from 3% of GDP to just 0.1% of GDP. At the beginning of 2013, the sum of the current and capital account balance turned positive again (on a 12-month cumulative basis), and for 2013 as a whole a surplus just

below 1% of GDP is estimated. This improvement is to a large extent due to that of the trade balance (Graph 3.6), in particular the non-energy component of the goods balance. Around three quarters of the goods balance correction over the period 2011-13 is due to a decline in nominal imports (by more than 10%), driven in particular by depressed domestic demand (Graph 3.8). Nevertheless, exports also contributed to the improvement of Italy's external balance: they grew by 3.6% in nominal terms over the period 2011-13, and were mainly driven by demand from outside the euro area (see Section 3.2.1). Also, Italy's trade balance is quite sensitive to fluctuations in energy import prices, given the structural dependence on imported energy (the average current account deficit for Italy over the period 2007-11 broadly overlapped with the average energy trade deficit). While the ongoing diversification of energy sources could make the country somewhat less vulnerable to energy price shocks in the future, high dependence on imported energy is expected to remain a permanent feature of the Italian economy.

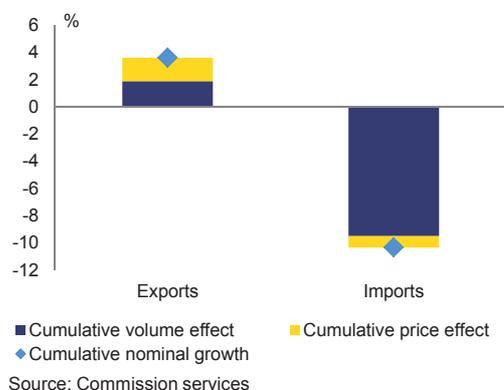


The correction of Italy's current account appears to be mostly non-cyclical. The deep and protracted recession in the country has constrained estimated potential output. Hence, domestic demand and imports are not expected to fully return to their pre-crisis level and trend. Although Italy's estimated output gap is quite large (-4.3% of GDP in 2013), the output gaps of the country's main trade partners are also negative, implying that foreign demand for Italian exports is still set to rise with trade partners' domestic demand when the



latter's output gaps close. Recent estimates ⁽⁷⁾ indicate that Italy's cyclically-adjusted current account balance was broadly balanced in 2013.

Graph 3.8: Decomposition of Italy's good balance correction over the period 2011-13



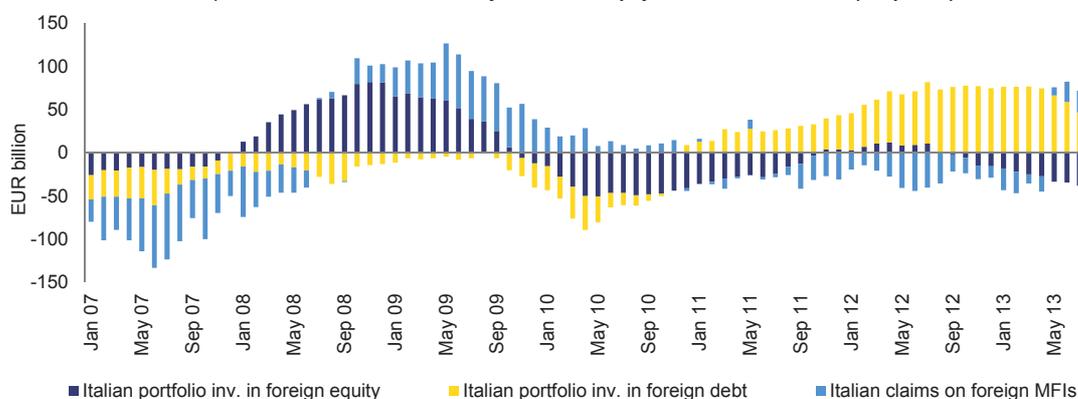
From a savings-investment point of view, a sharp fall in investment contributed the most to the recent current account correction. With the crisis, general government savings as a share of GDP reached a low in 2009 mainly due to the work of automatic stabilisers, whereas consumption smoothing triggered a sharp fall in households' savings. Eventually however, the decline in private savings was more than offset by the strong fall in gross capital formation due to the worsening economic outlook and tightening credit conditions. Under strong market pressure, the general government sector undertook a significant fiscal adjustment implying higher public savings,

and a reversal in the decline of private savings also became visible in 2013 as households started to adjust consumption to permanently lower income prospects (Graph 3.7). As a result, the current account balance turned positive in 2013. In 2014-15, the Commission Forecast projects a further increase in national savings due to the ongoing balance-sheet adjustment in both the government and the private sectors. At the same time, gross capital formation is expected to increase as (external) demand prospects improve and financial conditions gradually ease. Therefore, the current account surplus is set to stabilise at just over 1% of GDP.

The sharp correction in Italy's current account reflects the withdrawal of foreign private capital flows, but the latter trend started to reverse at the end of 2012. As of mid-2011, in the context of the euro-area sovereign debt crisis, foreign investors drastically reduced their exposure to longer-term Italian sovereign debt. Confidence-based contagion from the Italian sovereign to the Italian financial system also triggered large cuts in interbank loans and non-resident deposits with Italian banks and in foreign exposures to bonds issued by Italian monetary and financial institutions (MFIs) (Graph 3.10). Private-sector funding was to a large extent replaced by official-sector funding, notably by Italian sovereign bond purchases by the Eurosystem under the Securities Markets Programme (SMP) for around EUR 100 billion (around EUR 90 billion still to expire), and the strong increase in Italian banks' dependence on Eurosystem liquidity provision. The improved

⁽⁷⁾ European Commission (2014d)

Graph 3.9: Financial account of Italy's balance of payments – Italian assets (simplified)



Source: Bank of Italy

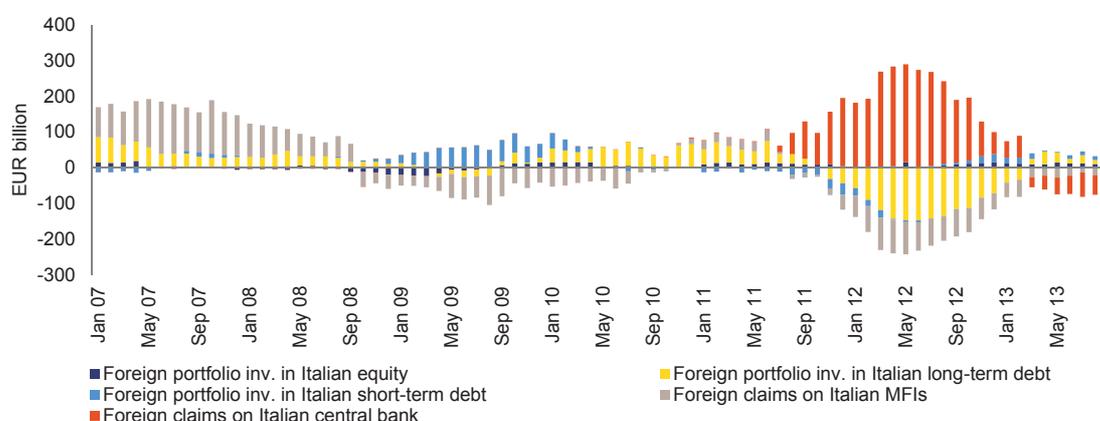
Note: Shown values expressed in 12-month moving-sum terms. A positive value indicates a decrease of Italian claims on foreign assets. A negative value indicates an increase in Italian claims on foreign assets. 'Italian claims on foreign MFIs' mainly represents currency, loans and deposits. Only the most relevant asset categories for the indicated period have been shown.

fiscal and external positions as well as the announcement of the ECB's Outright Monetary Transactions (OMT) programme in September 2012 and steps forward in completing the euro area's economic governance architecture were all factors that contributed to a recovery of investor confidence. This is reflected in lower spreads between Italian and German government bond yields, some recovery in demand for Italian sovereign securities by foreign investors, and renewed interest in Italian corporate equity and debt instruments. As a result Italian banks' reliance on Eurosystem refinancing fell from a peak of EUR 280 billion in February 2013 to EUR 230 billion at end-2013. Only the negative trend in

non-resident deposits and loans to Italian banks has not yet reversed, but the pace of outflows has decreased significantly. At the same time, Italian investors have been reducing their disposals of assets held abroad, which took place to mitigate the effect of the foreign capital outflows, and have been stepping up again their purchases of foreign equity instruments (Graph 3.9).

Despite a gradual deterioration, Italy's net international investment position (NIIP) remains moderately negative. Italy's NIIP has gradually deteriorated from -5% of GDP in 1999 to around -28% in 2013 (Graph 3.11), a moderate level compared to the one recorded in other

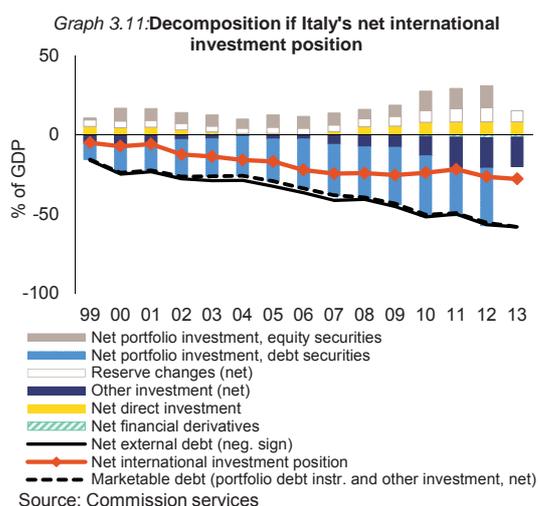
Graph 3.10: Financial account of Italy's balance of payments – Italian liabilities (simplified)



Source: Bank of Italy

Note: Shown values expressed in 12-month moving-sum terms. A positive value indicates an increase of foreign claims on Italian assets. A negative value indicates a decrease of foreign claims on Italian assets. 'Foreign claims on Italian central bank' mainly represents Italian banks' reliance on Eurosystem.

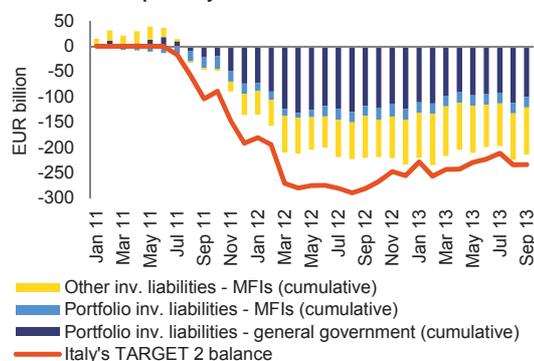
vulnerable economies such as Spain (-93.4% of GDP), Portugal (-119.4%) or Ireland (-110.5% of GDP). The composition of the financing of Italy's NIIP has however changed substantially since mid-2011. The NIIP is now also funded by the official sector, owing to ample liquidity made available by the Eurosystem in order to address the liquidity crunch in private interbank and capital markets which affected Italy and other vulnerable euro-area economies. In the context of fragmented euro-area financial markets, the large liquidity injection led to a large increase in Italy's TARGET2 liabilities vis-à-vis the Eurosystem (Graph 3.12). The overall net exposure of foreign investors to Italy has however remained broadly stable. ⁽⁸⁾



Italy's experience in 2011-12 shows that even a moderately negative NIIP can make a country vulnerable to a reversal of foreign capital inflows, with negative knock-on effects on the economy. Italy has to some extent managed to regain market confidence in recent months. Yet the country remains exposed to significant external refinancing risk in case of renewed risk aversion among foreign investors to finance its external liabilities, which are mostly in the form of debt instruments. Eventually, when the Eurosystem's current full-allotment liquidity provision ends, Italian banks will also have to reduce their reliance on this channel of financing. Going forward however, the achieved current account surplus – if not reversed – would allow Italy to gradually reduce its negative NIIP.

⁽⁸⁾ De Grauwe et al. (2012)

Graph 3.12: Main foreign capital outflows driving the build-up of Italy's TARGET 2 liabilities



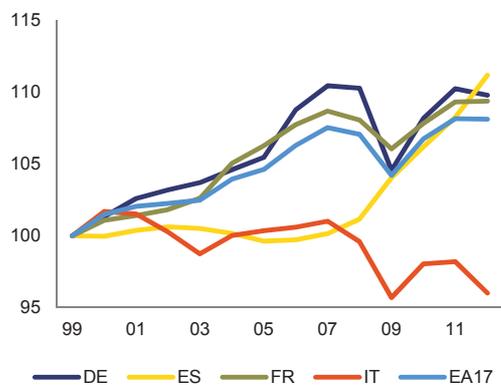
3.2.3. Cost/price competitiveness

Italy's external competitiveness has been hindered by growth in unit labour costs which has outpaced that in other euro-area countries.

Over the period 1999-2012, Italy's unit labour costs (ULC) has increased by 2.4% per year on average. This is above the euro-area average of 1.7% as well as the ECB's below-but-close-to 2% reference value for HICP-based inflation. Italy's relative ULC increase was mainly driven by a negative trend in labour productivity growth (Graph 3.13) – also reflecting labour hoarding in recent years – whereas nominal compensation per employee has grown broadly in line with the euro-area average. The evolution of ULC relative to main trade partners and the appreciation of the nominal effective exchange rate (NEER) since the beginning of the 2000s together explain the appreciation of Italy's real effective exchange rate (REER) based on ULC (Graph 3.14). ⁽⁹⁾ Ambitious reforms of the labour market and of the collective bargaining mechanism were introduced in recent years and are now gradually being implemented (see Box 3.2). These reforms can potentially foster a better alignment of wages to productivity through wage differentiation that appropriately addresses the large dispersion of productivity and labour market conditions across the country. Ultimately, this is also expected to improve the allocative efficiency of the economy and contain Italy's ULC growth through enhanced productivity (see Section 3.3).

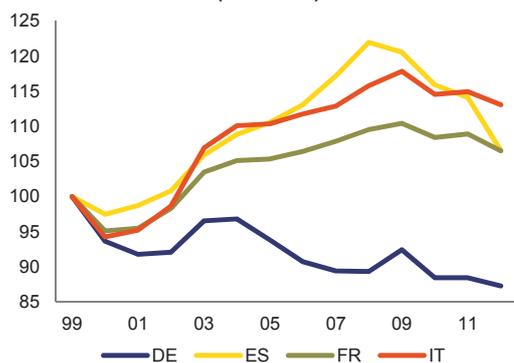
⁽⁹⁾ IMF (2013c) for instance estimates that in 2012 Italy's exchange rate could be overvalued by 0-10%, consistent with a gap between the cyclically-adjusted current account and the current account consistent with fundamentals and desirable policies of 0-2% of GDP.

Graph 3.13: Evolution of labour productivity (1999 = 100)



Source: Commission services

Graph 3.14: Evolution of the REER based on nominal ULC (1999 = 100)



Source: Commission services

Price-based REERs suggest a less unfavourable competitiveness position for Italy than ULC-based REERs. Graph 3.15 shows the evolution of the REER of Italy and some European peers based on producer prices (PPI) in manufacturing. In 2012, the PPI-based REER level was still close to the level recorded at the onset of the euro, despite the appreciation of the nominal effective exchange rate (NEER). It therefore provides a better picture of Italy's competitiveness than the ULC-based REER. Price-based REERs capture a wider range of production costs beyond domestic labour, but may also be influenced by other elements such as quality improvements and price-setting power. Giordano et al. (2013) argue that nominal ULC may not be the most representative indicator of a country's competitiveness. In particular, increasingly globalised value chains may imply a decreasing share of domestic factors in total production costs as inputs sourced from abroad increase at the expense of domestic labour. IMF (2013b) adapt the

REER framework to a world in which countries compete in the supply of value added (or 'tasks', rather than goods) and also find that Italy's cumulative loss of competitiveness since euro inception is less pronounced than when using ULC-based REER. ⁽¹⁰⁾ Nominal ULC however remain relevant as they signal the extent of domestic cost pressures on prices and profit margins.

Graph 3.15: Evolution of the REER based on producer prices in manufacturing (Jan 1999 = 100)

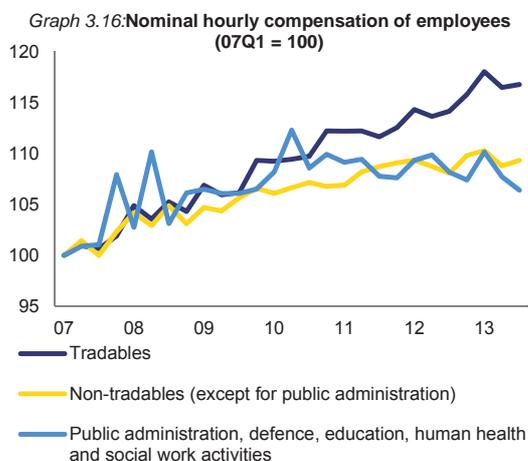


Source: Bank of Italy

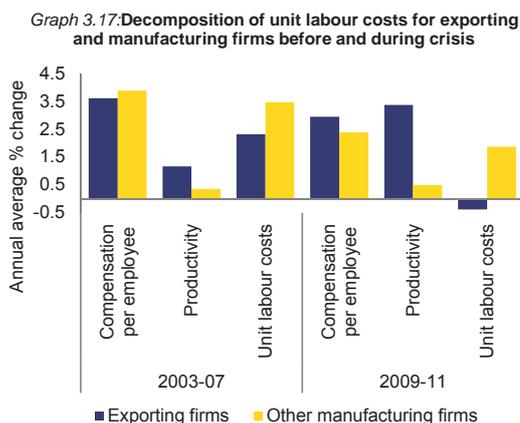
Wage moderation so far has been driven by the public and non-tradable sectors. Graph 3.16 shows diverging dynamics in nominal hourly compensation of employees by sector since the onset of the crisis. First, it illustrates a decoupling of the index in nominal hourly compensation for employees in tradable sectors from the corresponding index in the public sector ⁽¹¹⁾, which is explained by the public wage freeze enacted by the government since 2011. Second, it displays that also the other non-tradable sectors experienced more moderate wage dynamics than tradable sectors. This could be explained by the weaker productivity dynamics in non-tradable sectors. Graph 3.17 sheds light on ULC developments in the manufacturing sector, distinguishing between exporting firms and other firms. It shows that, during the crisis, wage growth has been more dynamic in exporting firms, while the opposite was true in the pre-crisis period. However, as exporting firms have displayed higher productivity growth than other firms in both periods, ULC growth has been more contained.

⁽¹⁰⁾ See for instance Giordano et al. (2013) and IMF (2013b).

⁽¹¹⁾ The public sector is represented here by 'Public administration, defence, education, human health and social work activities' as in NACE Rev. 2.



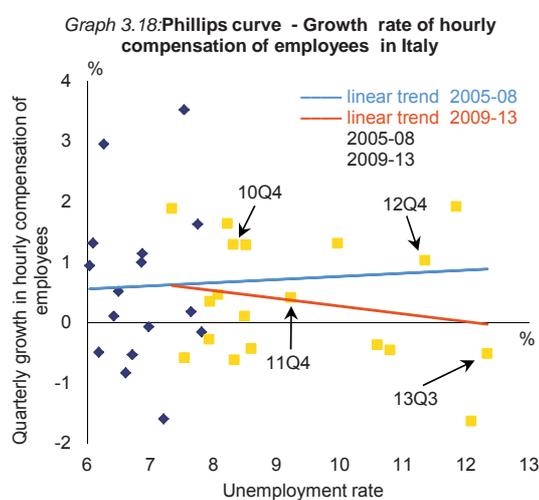
Source: Commission services, Istat



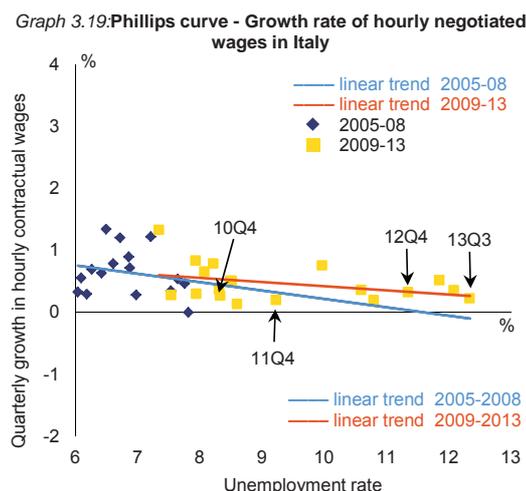
Source: Commission services, Confindustria, Istat

Contractual wages so far have been less responsive to labour market conditions than actual compensation. There are considerable differences between the dynamics of actual wages (hourly compensation of employees based on national accounts) and those of negotiated hourly wages. Compensation of employees has been growing faster than negotiated wages until 2008, driven by a positive wage drift. Since the onset of the crisis however, contractual wages have been less reactive to the negative economic cycle than actual wages, indicating negative wage drift. Graphs 3.18 and 3.19 show the Phillips curves that relate the unemployment rate to the growth of negotiated wages and to hourly compensation of employees in national accounts respectively. In both graphs, two curves are shown, one for the pre-crisis years 2005-08, and one for the crisis period 2009-13. The Phillips curves based on actual wages indicate that the almost flat relationship between the unemployment rate and

wage growth before the crisis changed into a negative relationship after the crisis. By contrast, the Phillips curve based on contractual wages has flattened during the crisis, indicating low responsiveness of wages to labour market conditions. As indicated in Box 3.2, this may be related to some features of the wage-setting system in Italy. It can be expected that contractual wages for contracts due to be renewed in 2014 will adjust to lower expected inflation (at end-2013, 32.4% of contracts needed to be renewed).



Source: Commission services

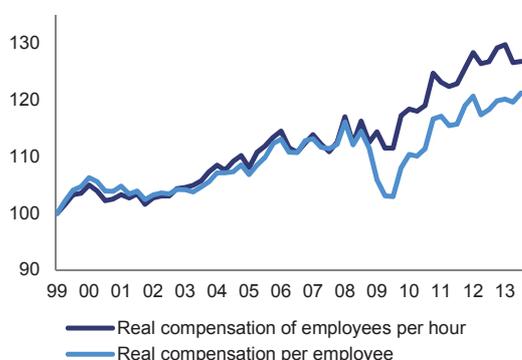


Source: Commission services

Composition effects may mask some of the ongoing wage adjustment. At the onset of the crisis, the reduction in employment mainly affected workers on temporary or atypical contracts, which are typically paid less than

workers on regular contracts. Meanwhile, the increase in retirement age enacted with successive pension reforms has prolonged careers. As a result, between 2007 and 2012 the share of people aged 50-74 in total employment increased by almost 5 pps. while the share of young people (aged 15-24) diminished by 1.5 pps. Ceteris paribus, this implies an increase in the average wage level because older workers are usually paid more than younger ones (see Section 3.3).

Graph 3.20: Real compensation of employees in industry excluding construction (99Q1 = 100)



Source: Commission services, Istat

Real wages have been adjusting mainly through a reduction in hours worked. Graph 3.20 shows annual growth in real compensation of employees in the industrial sector (excluding construction) over the period 2007-13, in both hourly terms and per employee.⁽¹²⁾ As the economy contracted in 2008 and 2009 and working hours fell, real wages per employee declined significantly. When working hours stabilised and even slightly increased in 2010-11 thanks to the recovering economy, the rise in real wages resumed. However, firms that hoarded labour in the first phase of the economic crisis started to dismiss workers as of mid-2011 when the economy fell again into recession. Since then, unemployment has risen steadily from 7.9% in Q2 2011 to 12.3% in Q3 2013. In response to this, real wage growth has decelerated, in both hourly terms and per employee. In particular, during the second and third quarters of 2013, nominal hourly wages in manufacturing have grown in line with inflation. Going forward, real wage adjustment may become

⁽¹²⁾ Real compensation is calculated by using the gross-value-added deflator of industry excluding construction.

more difficult to achieve in a context of low inflation.

Shifting taxation away from productive factors would make the tax system more growth-friendly, while improving cost competitiveness in the short term. The tax burden on labour in Italy is very high compared with the EU average. The implicit tax rate on labour was 42.3% in 2011, the second highest in the EU and well above the EU average of 35.8%.⁽¹³⁾ The tax wedge for the average-wage single worker stood at 47.6% in 2011 and 2012, also above the EU average. In contrast, the implicit tax rate on consumption in 2011 (17.4%) was below the EU average (20.1%).⁽¹⁴⁾ Overall revenues from taxes on property were in line with the EU average of 2.1% of GDP in 2011, with an elevated component stemming from taxes on property transactions. In 2012, the recurrent component – which is considered the least detrimental to growth – is estimated to have increased from 0.7% to around 1.5 % of GDP. A small step in reducing the tax burden on labour was taken with the 2014 budget while the standard VAT rate was increased from 21% to 22% in October 2013. A further shift in taxation away from productive factors in a budgetary neutral way would contribute to an improvement in cost competitiveness in the short term and support labour and capital accumulation. Although favourable, this fiscal strategy cannot be a substitute for deeper structural reforms to enhance competitiveness since the permanent effects of a tax shift are likely to be small in size.⁽¹⁵⁾ In addition, it has to be noted that the scope to reduce the labour tax wedge is constrained by the need to ensure adequate pensions under the new contributory system, which closely links contributions paid and future benefits.

⁽¹³⁾ It would be even higher if the part of the regional tax on economic activities (IRAP) weighing on labour were included.

⁽¹⁴⁾ The implicit tax rate on labour is calculated as the sum of all direct and indirect taxes and social contributions levied on employed labour income as a percentage of total compensation of employees from national accounts. The implicit tax rate on consumption is the ratio between the revenue from all consumption taxes and the final consumption expenditure of households (European Commission (2013b)).

⁽¹⁵⁾ Koske (2013)

Box 3.2: The labour market reform and collective bargaining framework

An ambitious reform to improve the functioning of the labour market was introduced in 2012, followed up by some measures to foster the employability of young people. Meanwhile, the collective bargaining framework has continued to evolve, further shifting the scope of decentralised bargaining.

The 2012 reform aimed to address the rigidities and dualism of the Italian labour market. In particular, it focused on enhancing exit flexibility for workers on open-ended contracts through amendments to the rules and procedures regulating dismissals, while regulating entry flexibility by reducing incentives to hiring workers on non-permanent contracts and making apprenticeships the main point of entry towards stable jobs. It also introduced a more inclusive insurance-based system of income support for the unemployed, which will become fully operational as of 2017. The reform is slowly being implemented, with mixed evidence on its effects, also because it is difficult to disentangle the impact of the reform from the impact of the crisis. There is some evidence of a reduction of both the length of dismissal procedures – in particular thanks to the new mandatory conciliation and simplified court procedures for dismissal cases – and the number of compulsory reinstatements of dismissed workers in firms. Concerning the use of employment contracts, available data up to Q3 2013 show a steady decline of open-ended hires and reduction in the use of atypical contracts (jobs on call, collaboration contracts) in favour of temporary contracts, in spite of the increase in employers' social security contributions stipulated by the reform. Disappointingly, the take-up of apprenticeship contracts falls well below expectations. ⁽¹⁾ Finally, the new unemployment benefits system is being put under strain by the increase in unemployment and is not supported by effective activation policies to help people go back to work, highlighting persistent weaknesses in the functioning of public employment services, especially in some regions.

In a country like Italy, characterised by great dispersion in productivity and labour market outcomes across different areas and firms, decentralised bargaining can play an important role in strengthening wage responsiveness to productivity as well as to local labour market conditions. The crisis probably gave new impetus to the trend towards the decentralisation of the bargaining structure within the two-tier framework that was formalised with the 1993 tripartite agreement. Important agreements were signed by social partners in 2009, 2011 and 2012, the latter with the support of the government through tax rebates on productivity-related wage increases. A further important agreement was signed in early 2014 to define the criteria to measure trade unions' representativeness in collective bargaining, at both sectoral and firm level. The new criteria could bring stability in industrial relations and foster decentralisation. However, they only cover the industry sector for the moment. The evidence available so far shows that firm-level contracts still concern a minority of workers and firms, with the share being particularly low in southern regions and having actually decreased during the crisis. This may be due to the prevalence of small firms, with scarce unionisation and limited propensity by both employers and employees to engage in bargaining, and also to the limited use of concession bargaining, whereby workers accept temporary downward deviations from pay negotiated at national sectoral level in exchange for investments at firm level aimed at improving work organization and production efficiency. The 3-year duration of contracts, while reducing negotiation costs, may be too long to adjust to unexpected changes in cyclical and competitiveness conditions. The link with expected inflation (net of imported energy prices) in wage-setting at national level over three years is a further source of nominal wage inertia, particularly in the current context of low inflation.

⁽¹⁾ ISFOL (2013b), Rosolia (2013), Ministero del Lavoro e delle Politiche Sociali (2014)

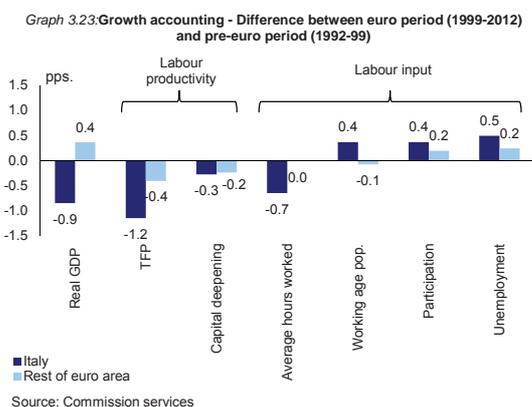
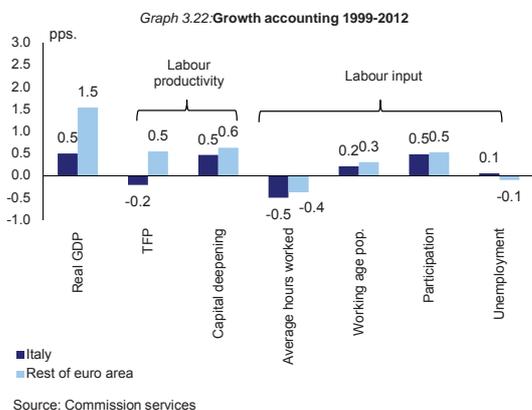
3.3. ITALY'S PRODUCTIVITY CHALLENGE

Italy's dismal productivity growth is at the root of the country's macroeconomic imbalances. Italy's total factor productivity (TFP) growth came to a halt at the end of the 1990s and has been subdued and even negative ever since. Weak

productivity growth hampers competitiveness, both through cost effects (affecting the efficiency of producing a given item) and non-costs effects (product mix, quality upgrading and after-sale services) ⁽¹⁹⁾. Stagnating productivity also entails

⁽¹⁹⁾ See ECB (2012) for an extensive review of productivity and competitiveness relationships.

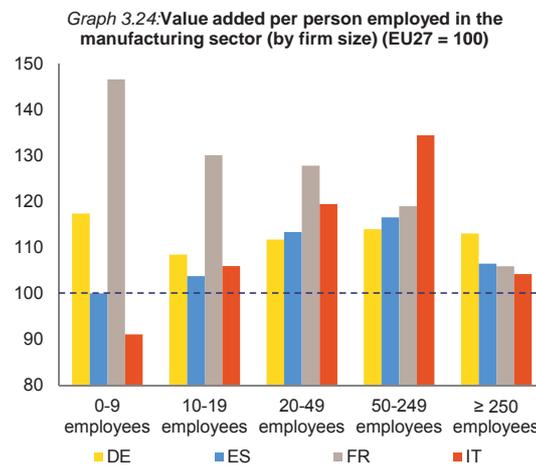
low GDP growth (Graphs 3.22 and 3.23) which affects debt dynamics.



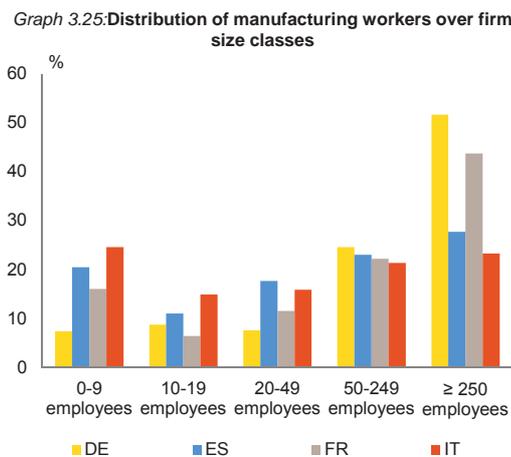
Slow productivity growth is driven by allocative inefficiencies. Long-standing weaknesses in governance structures and public administration slow down the reallocation of resources towards more productive sectors and firms. At the same time, insufficiently developed capital markets hold back technological innovation and absorption. Labour market rigidities and the education system hamper human capital accumulation. Recent research indicates that such conditions deter FDI and hamper firm-level productivity, in turn holding back the expansion and internationalisation of firms. ⁽²⁰⁾ Graphs 3.24 and 3.25 show Italy's high share of small and on average less productive firms in the manufacturing sector. Industrial districts, a traditional feature of the Italian economy, help Italian firms to partially compensate their size disadvantage through clustering. Firms within industrial districts perform better in relative terms

⁽²⁰⁾ See for instance European Commission (2013a) and Altomonte et al. (2012).

with respect to a range of indicators, including turnover growth during the crisis, innovation and internationalisation. ⁽²¹⁾



Source: Commission services



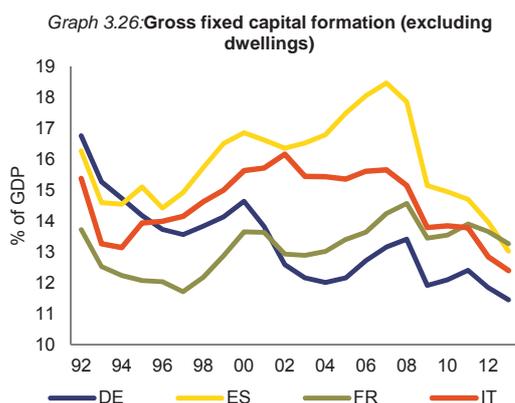
Source: Commission services

3.3.1. Capital allocation and innovation

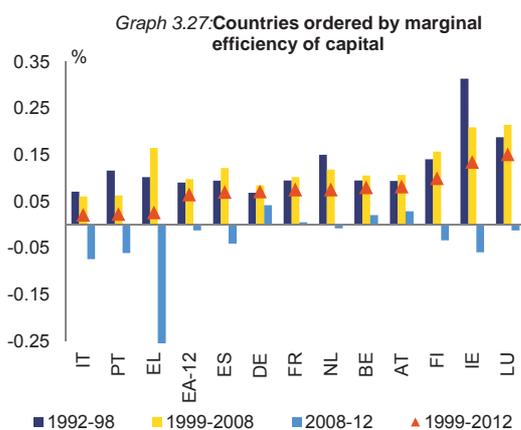
Italy's investment rate is comparable to that in other euro-area countries, but its level of capital efficiency is lower and declining. Graph 3.26 shows that gross fixed capital formation (excluding dwellings) in Italy is comparable to that of its peers, including during the crisis when a sharp decline occurred (also relative to other GDP components). While capital deepening has a continuous positive impact on labour productivity

⁽²¹⁾ See for instance Intesa Sanpaolo (2013). Within clusters, divergence among firms in terms of performance still exists.

(Graph 3.22), the observed accumulation pattern does not seem to have led to rapid technological change and TFP growth, as shown by the low and declining the marginal efficiency of capital in Italy (Graph 3.27).⁽²²⁾



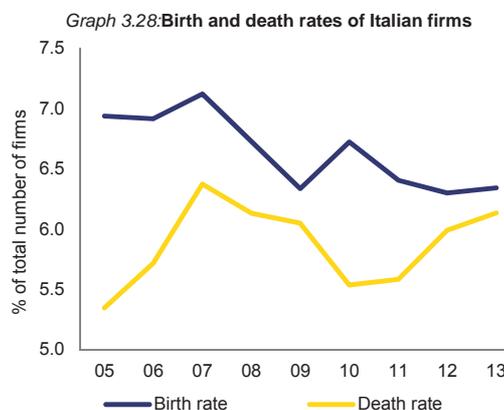
Source: Commission services



Source: Commission services

The quality of investment in Italy, rather than its quantity, appears to be weak. Hassan et al. (2013) provide tentative evidence of capital misallocation by showing that there was no correlation between loan growth (the main source of investment financing) and TFP across sectors over the period 1999-2007. Another indicator of the limited ability of the economy to reallocate resources towards more productive firms and sectors is the rather stable death rate of firms against the background of falling birth rates (Graph 3.28). While pointing to some resilience in

Italy's productive system, this could also indicate inertia in the country's allocative efficiency.⁽²³⁾



Source: Unioncamere, Commission services

Technology absorption and innovation remain low. Chart 3.29 (reproduced from Hassan et al. (2013)) analyses the composition of Italian investment, focusing on ICT. It shows that Italy recorded shares of ICT in total non-residential investment similar to France and Germany only until the mid-1990s. The economic literature provides robust evidence that such differences in countries' ability to absorb new technologies, notably ICT, were at the root of divergent productivity developments, within and outside Europe.⁽²⁴⁾ The low technology absorption and innovation capacity reflects the traditional bias of the Italian economy towards low and medium-low technology sectors (Section 3.2). Private R&D spending in Italy is particularly low (0.7% of GDP in 2012, compared to 1.9% in Germany and 1.3% on average in the EU). The number of patents per million inhabitants is also low (63.5 in 2011), half and less than a quarter of the French and German figure respectively. The use of aggregate official statistics such as R&D expenditure or the number of patents may underestimate the innovative efforts of Italian firms, given the dominant presence of SMEs. For instance, Benvenuti et al. (2013) show that 53% of Italian firms introduced some innovation over the period 2008-10, only slightly less than in France and in line with Finland and the Netherlands. However, evidence also shows that when product innovation is taking place, Italian firms have a lower capacity to register patents

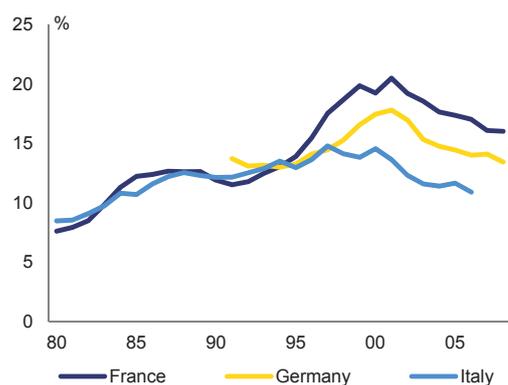
⁽²²⁾ The marginal efficiency of capital is defined as the change in GDP at constant market prices of year t per unit of gross fixed capital formation at constant prices of year $t-5$.

⁽²³⁾ See also European Commission (2013d)

⁽²⁴⁾ McMorro and Roeger (2014), Inklaar et al. (2008), Oulton (2010), Colecchia et al. (2001)

and/or designs, trademarks and copyrights. They also have lower shares of sales from innovative products and lower shares of products that are new to the market (and not only to the company itself).⁽²⁵⁾

Graph 3.29: Share of ICT investment in total non-residential

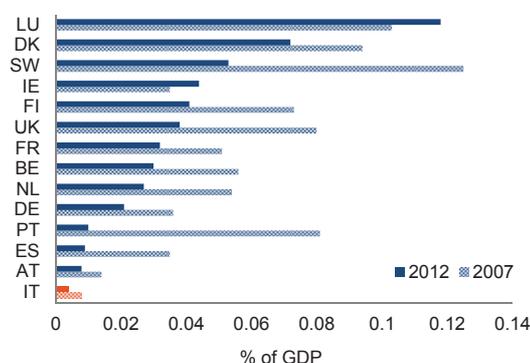


Source: OECD

Insufficiently diversified capital markets may have contributed to this result. Capital flows into low productivity activities in sheltered non-tradable sectors driven by rent-seeking rather than by efficiency considerations may in part explain the inefficient investment patterns outlined above.⁽²⁶⁾ Some underlying drivers are discussed in Section 3.3.3. The literature points to the role of insufficiently developed capital markets in hindering structural changes in the economy and sustaining the growth of innovative SMEs. The uncertain returns over a relatively long time horizon, winner-takes-all effects, information asymmetries and the absence of collateral imply that equity is more adequate than debt for financing innovation. In particular, venture capital and funds from business angels – two specific forms of private equity – constitute the main private-sector solutions to the problem of financing innovation, in particular for small and start-up firms. The financial structure of Italian firms, including the most innovative, is however characterised by a higher incidence of bank loans than in other euro-area and Anglo-Saxon countries (66% in 2012, compared to 50% and 30% respectively), which is especially problematic in the current context of tight credit conditions.⁽²⁷⁾ The debt bias reflects inter alia the dominant role

of banking in financial intermediation, the relatively high share of Italian firms that are wholly family-owned – which might imply reluctance to give up control through equity issuance – and the underdevelopment of equity capital markets in Italy, in particular the venture capital market (see Graph 3.30). These findings suggest that Italian innovative start-up firms are more constrained in obtaining funding than innovative companies in other European countries, limiting the innovative capacity and reactivity of the economy as a whole.

Graph 3.30: Venture capital investments in selected EU countries



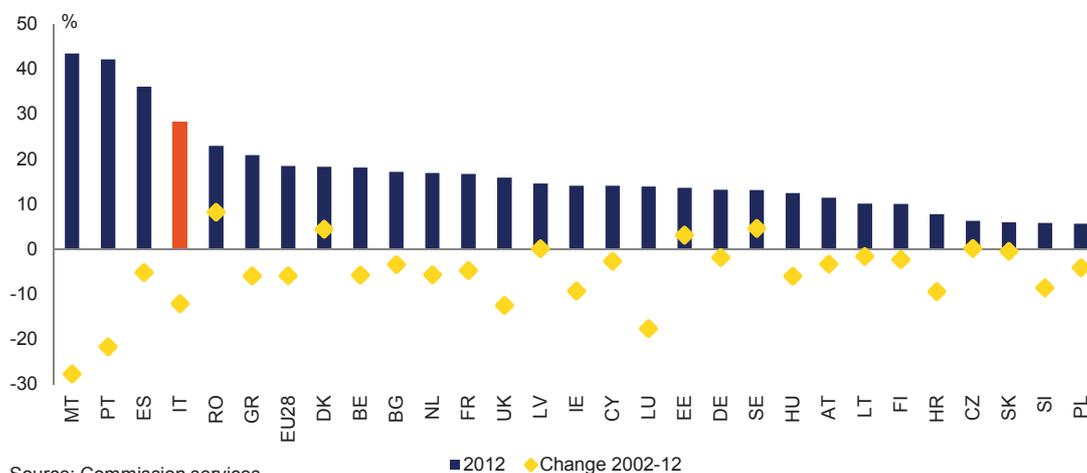
Source: Commission services

⁽²⁵⁾ Benvenuti et al. (2013), Bugamelli et al. (2012)

⁽²⁶⁾ Balta (2013)

⁽²⁷⁾ Bank of Italy (2013a), Magri (2007)

Graph 3.31. Share of population aged 25-34 with less than upper secondary education (ISCED levels 0-2)



Source: Commission services

■ 2012 ◆ Change 2002-12

3.3.2. Human capital accumulation

Human capital appears inadequate to the needs of a modern competitive economy.

In 2011, Italy had the fourth highest share of population with only basic education and the lowest share of population with tertiary education in the EU. Particularly worrying are the low attainment rates for adults, but also for young cohorts (Graph 3.31 and 3.32) pointing to a further widening of the skill gap in the future. Similar evidence emerges regarding skills: notably in the OECD PIAAC⁽²⁸⁾ Survey, Italy ranks at the bottom in literacy among the countries participating in the survey and only above Spain in mathematic skills. Moreover, Italy's results are highly polarised. At the top end, only 3.3% of Italians reach the highest score for literacy (OECD average of 11.8%) and 4.5% for mathematics (around 10% for the OECD average). At the bottom, 27.7% of Italians have literacy competences at or below the minimum level (OECD average of 15.5%). Older people score particularly weakly, but the younger generation also underperforms.

Knowledge and skills of students differ significantly across regions.

In terms of quality, according to the OECD's 2012 PISA⁽²⁹⁾ survey, Italy's 15 year-old pupils continued scoring significantly below the OECD average across the

reading, mathematics and science scales, although results have improved compared to previous PISA rounds.⁽³⁰⁾ At the same time however, Italy fares relatively well in recent studies of 10-years old pupils (concerning literacy and reading as well as mathematical and science skills).⁽³¹⁾ There are important regional variations in scores, with northern regions faring generally better than southern regions and centre regions close to Italy's average. In PISA, for instance, students from Trento, Veneto, Friuli-Venezia Giulia and Lombardy tend to have average scores well above the OECD average.⁽³²⁾

Drop-out rates during both secondary and tertiary education are high and adult education is not sufficiently developed.

The percentage of 18-24-year olds leaving school without upper secondary education was 17.6% in 2012, i.e. 5 pps. higher than the EU-27 average and still above the national target for 2020 (15-16%). In particular, the drop-out rate is very high during the first year of upper secondary education, revealing a difficult transition from the lower to the upper secondary level. There are substantial regional variations: the rate varies from around 15% in northern and centre

⁽³⁰⁾ Italy's data at national level mask very wide regional disparities: performance is in line with or above the OECD average in northern regions but significantly worse in southern regions.

⁽³¹⁾ See the 2011 results of the Trends in International Mathematics and Science Study (TIMSS) and Progress in International Reading Literacy Study (PIRLS) by the International Association for the Evaluation of Educational Achievements.

⁽³²⁾ Invalsi (2014)

⁽²⁸⁾ Programme for the International Assessment of Adult Competencies; the survey is carried out among adults aged 16-65 in 24 countries.

⁽²⁹⁾ Programme for International Student Assessment

regions to 25% in Sicily and Sardinia (20% in the rest of the south). The drop-out rate is also very high at tertiary level. According to OECD (2008), which contains the most recent data (2005), the tertiary drop-out rate in Italy (55%) was the highest among OECD countries. At later stages in working life, the participation of Italian adults to formal and non-formal adult education and training is among the lowest in PIAAC countries (24% of workers vs. the OECD average of 52%).

Public spending on education is below the EU average, especially for tertiary education. Italy's public spending on education amounts to around 4.5% of GDP, 1 pp. lower than the EU average, mainly due to lower spending on tertiary education. This also reflects the lower-than-average attainment rates as spending per student in purchasing power standard for ISCED 1-6 combined is broadly in line with the EU-27 average.

QUEST simulations show that human capital weaknesses could explain a significant part of Italy's productivity gap. Results from the Commission's QUEST III simulations to assess the impact of comprehensive packages of structural reforms across EU countries (including spillovers) indicate that human capital plays an important role in explaining Italy's productivity gap. Notably, closing half of the gap to the three best performing EU countries in the attainment rates at both ends of the skill scale could increase GDP by 8% over the baseline in the long run. This represents nearly half of the potential gain from the whole set of reforms simulated. Because of the relevance of cohort effects to human capital reforms, Italy's gains from structural reforms over the first 10 simulation years are smaller than for other countries. ⁽³³⁾

The Italian labour market does not appear to sufficiently value education and skills. Returns to education are estimated to be lower in Italy than in other developed countries. The OECD estimates that, for a man, the internal rate of return from attaining tertiary education over secondary education is only 8.1% over the lifetime, i.e. 5.5 pps. less than EU-21 average of 13.8%. For a woman, the rate of return is 6.9%, compared to the EU-21 average of 12.1%. Internal rates of return also create a disadvantage for men and women

attaining upper secondary education with respect to primary and lower secondary education. ⁽³⁴⁾ This is consistent with available micro-econometric evidence showing that an additional year of education in Italy increases current earnings by about 5%, at the lower end of the 5-15% range reported in the literature. Hanushek et al. (2013) calculate the return to skills using the OECD's PIAAC results. They find that in Italy, a standardised increase in numeracy skills is associated with a 13% wage premium for prime wage workers (aged 35-54), lower than the 18% average and the fourth lowest among the OECD countries covered by PIAAC (after Nordic countries, which have however a more equal wage distribution). ⁽³⁵⁾

Seniority matters more than education, reducing incentives to invest in skills and education. Hanushek et al. (2013) find that in Italy, the return to skills for older workers (those aged 55-65) is 12.3 pps. higher than for young adults (aged 25-34), substantially outpacing the return according to cross-country evidence. This is consistent with Italy's age-earnings profile (Graph 3.33) which is flatter than in other countries until the mid-40s and steeper only thereafter. Rosolia et al. (2007) document a significant deterioration in real entry wages since the early 1990s (although the level of education of new entrants was increasing), resulting in increasing wage and lifetime earnings differentials between those entered the labour market before and after. They argue that this effect was primarily driven by the successive reforms of the labour market that generated a dual market where the burden of adjustment was borne only by (young) new entrants. ⁽³⁶⁾

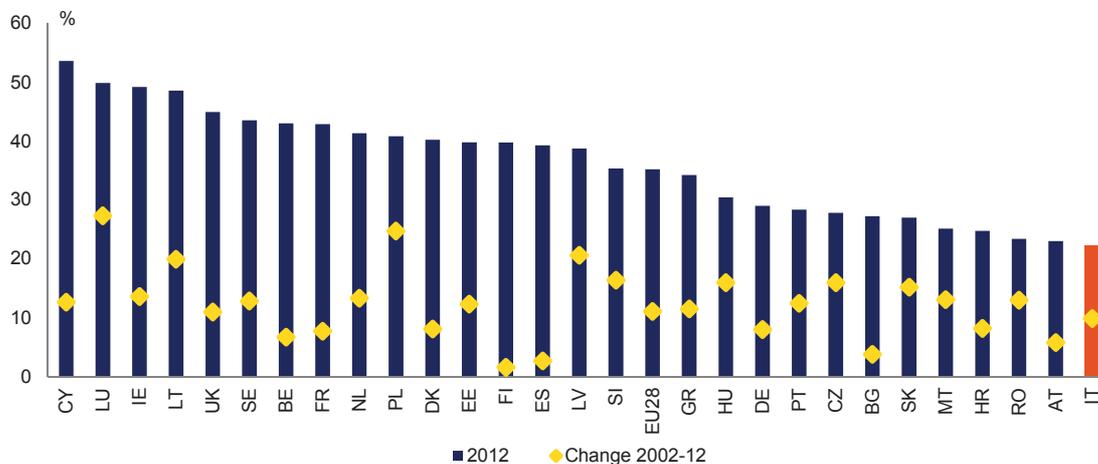
⁽³⁴⁾ The private internal rate of return is equal to the discount rate that equalises the real costs of education during the period of study to the real gains from education thereafter. In its most comprehensive form, the costs equal tuition fees, foregone earnings net of taxes adjusted for the probability of being in employment minus the resources made available to students in the form of grants and loans.

⁽³⁵⁾ Hanushek et al. (2013)

⁽³⁶⁾ Rosolia et al. (2007)

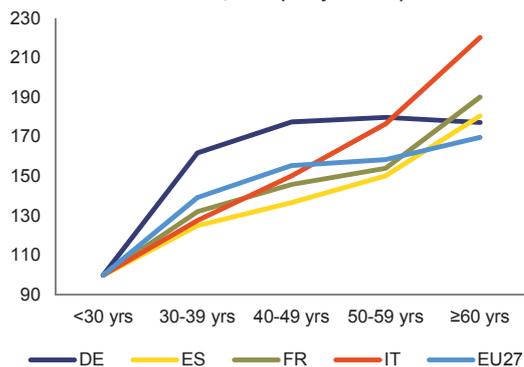
⁽³³⁾ Varga et al. (2013)

Graph 3.32: Share of population aged 25-34 with tertiary education (ISCED levels 5-6)



Source: Commission services

Graph 3.33: Age-earnings profiles in major European countries, 2010 (<30 yrs = 100)



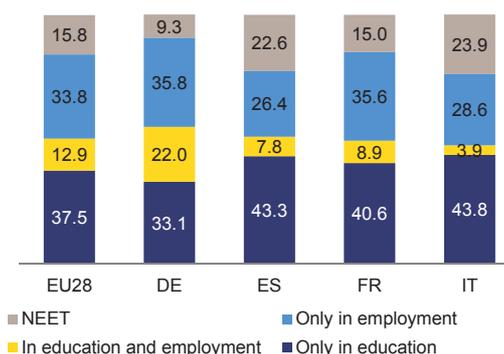
Source: Commission services

There is also evidence of a difficult transition from education to work. The ISTAT Labour Force Survey's (LFS) ad-hoc module for 2009 showed that the average time between leaving education and starting the first job was 10.5 months for Italy, second only to Greece (13.5). Also, the share of NEET (young people aged 15-29 not in education, employment or training) was at 24% in 2012, the third highest in the EU.

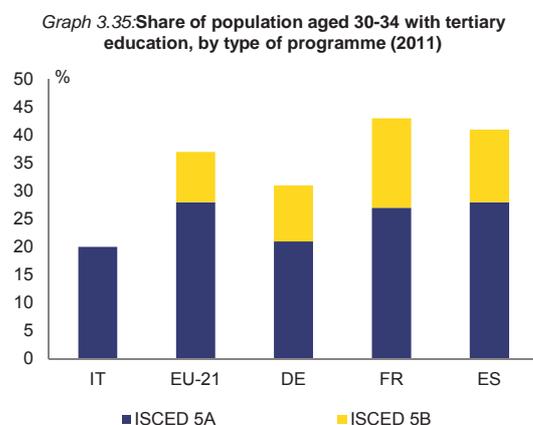
Vocational training shows important shortcomings. At secondary level, vocational training is developed but insufficiently work-based: the share of young people studying and working at the same time is 3.9% vs. the EU average of 12.9% (Graph 3.34). The 2012 labour market reform attempts to modernise apprenticeship contracts (Box 3.2), but professional apprenticeship contracts (the most

used) foresee only a limited education content (120 hours in 3 years) and no educational or professional qualification, which limits the potential of the reform to close the hiatus between the education system and the labour market. At tertiary level, vocational training was missing until very recently, which contributed to a large extent to Italy's gap in attainment rates for 30-35-year olds (Graph 3.35). Italy has recently introduced tertiary-level vocational institutions, the impact of which will only be seen in the future.

Graph 3.34: Share of population aged 15-29 by education and employment status, 2012



Source: Commission services



Source: OECD (2013a)
 Note: ISCED 5A and 5B respectively stand for tertiary education type-A and type-B programmes, as defined by the OECD.

3.3.3. Underlying weaknesses in governance and public administration

Labour and product market regulations have improved since the late 1990s, but the positive impact on growth has not yet materialised. The OECD synthetic index for Product Market Regulation (PMR) is now in line with the OECD average, while it was among the most restrictive in 1998. Correspondingly, mark-ups in services have on average declined substantially and are now among the lowest in the EU. ⁽³⁷⁾ The OECD synthetic index for employment protection legislation (EPL) also indicates that employment regulation in Italy is now less strict than in France and Germany. ⁽³⁸⁾ So far, these reforms were however not sufficient to induce factor reallocation and reignite productivity growth. While some barriers to competition in certain services (including in professional services, retail distribution, postal services, waste and local transportation) and rigidities in the labour market remain (as discussed in Section 3.2), this also points to more fundamental issues that hamper the functioning of labour and product markets irrespective of regulation in place. ⁽³⁹⁾

Progress in public administration efficiency, including justice, and in improving the business environment has been limited. The World Bank's 2013 Worldwide Governance Indicators show that

⁽³⁷⁾ Varga et al. (2013)

⁽³⁸⁾ An analysis of the functioning and reform of the labour market is carried out in Box 3.2 in Section 3.2.3.

⁽³⁹⁾ European Commission (2013c), OECD (2014).

Italy's performance on the perception indicators relating to government effectiveness, control of corruption and rule of law has been deteriorating since 2000 and is among the lowest in the EU. ⁽⁴⁰⁾ According to the World Bank's Doing Business indicators ⁽⁴¹⁾, Italy's is among the worst EU Member States also with regard to its business environment. In particular, starting a company remains very costly, while contract enforcement and tax compliance are very cumbersome. ⁽⁴²⁾ Trade potential is also hampered by slow and costly port procedures and lack of adequate intermodal connections. In addition to the direct costs on businesses (weighing on cost-competitiveness), an extensive literature shows that those factors also have sizeable negative effects on growth by hindering FDI and firm growth, constraining labour participation and hampering reallocation. Giacomelli et al. (2012) for instance show that halving the length of civil proceedings would increase the average size of firms by 8-12%. ⁽⁴³⁾ Furthermore, there is evidence that inefficiencies in public administration, and particularly the insufficient coordination between the different layers of government, have hampered the effective implementation of adopted measures. ⁽⁴⁴⁾

Corruption and tax evasion remain pervasive.

The first EU anti-corruption report highlights the extent of corruption in the country and analyses the underlying drivers and consequences for the economy and for citizens' trust in the government and institutions. ⁽⁴⁵⁾ Tax compliance remains low and time-consuming for Italian taxpayers (269 vs. 178 hours on average in the EU for mid-sized companies in 2013) ⁽⁴⁶⁾. An enabling law proposed in 2012 to enhance the tax system has just been approved by Parliament. ISTAT (2012) shows that

⁽⁴⁰⁾ Available at www.govindicators.org.

⁽⁴¹⁾ The World Bank (2013)

⁽⁴²⁾ Available at www.doingbusiness.org.

⁽⁴³⁾ Giacomelli et al. (2012). See Esposito et al. (2014) for a review of studies on the economic consequences of an inefficient civil justice system.

⁽⁴⁴⁾ European Commission (2013c)

⁽⁴⁵⁾ European Commission (2014b)

⁽⁴⁶⁾ For VAT, a study commissioned by the European Commission estimated that the tax gap (i.e. the difference between the theoretical tax liability according to the tax law and the actual revenues collected, as a share of theoretical tax liability) averaged 26% over the period 2000-11 placing the country in the fifth quintile across the 26 EU Member States covered in the study. See CASE (2013).

tax evasion/elusion is larger in sectors characterised by very low productivity growth and a large share of micro-enterprises, for which the possibility of evading/eluding taxation represents a de facto disincentive to grow.⁽⁴⁷⁾

Firms' governance and management appear inadequate to foster productivity growth.

The share of family ownership in Italy (86%) is not highly different from the one observed in France (80%) and Spain (83%) and even lower than in Germany (90%). However, Italian family-owned firms tend to be also family-managed, with limited recourse (only one third) to external managers. The recourse to external managers is significantly higher in family-owned firms in Spain (two thirds), Germany and France (in both cases around three fourths).⁽⁴⁸⁾ Recent firm-level research shows that the combination of family ownership and management (as prevailing in Italy) tends to hinder good quality management, which in turn hampers productivity-enhancing investment and innovation (as reflected in the low penetration of ICT).⁽⁴⁹⁾ In addition, despite the progress in opening product markets to competition, the scope of enterprises directly or indirectly controlled by central, regional or local governments, remains important. There is some evidence that such existing ownership and governance structures may not be optimal. For instance, recent IMF stress tests⁽⁵⁰⁾ find that banks controlled by foundations are more vulnerable to shocks than other banks and the Competition Authority points to inefficiencies in local services (such as local transportation and waste) rendered by companies owned by municipalities and operating under direct concessions.

3.4. EURO-AREA SPILLOVERS

Italy is deeply interlinked with other euro-area countries. On the one hand, Italy's adjustment may have a deflationary and contractionary effect on the rest of the euro area and its high debt increases the probability of renewed tensions in sovereign debt markets through the confidence channel. On the other hand, an overvaluation of the euro and a long period of low inflation also in non-

vulnerable countries would narrow the scope for price adjustment to recover competitiveness and make it more difficult to reduce Italy's debt-to-GDP ratio.

3.4.1. Trade and financial linkages between Italy and the rest of the euro area

Italy represents around 16.5% of overall euro-area output and is tightly linked to other euro-area countries through trade and financial links. Concerning trade links, Italy is among the most important export markets for other large euro-area economies such as Germany, Spain or France, as well as for neighbouring country Slovenia. With regard to financial links, Italy's NIIP shows that in 2010, France had a net asset position vis-à-vis Italy of almost 19% of its GDP, while Germany, Luxembourg and the Netherlands together held net assets in Italy amounting to around 7% of its GDP. Italian government debt held by other residents of the euro area at the end of August 2013 amounted to EUR 711 billion, or 7.4% of euro-area GDP. This implies that any losses on Italian assets would predominantly affect France and other euro-area partners. On the other hand, Italy held significant net assets in the rest of the world amounting to around 17% of its GDP.

Data on the cross-border exposures of the banking sector show the crucial importance of Italy for the French banking sector. Banking exposures constitute an important share of the overall foreign asset/liability position. Gross liabilities of Italian banks vis-à-vis French banks expanded at a fast pace in the run-up to the financial crisis and are now at around EUR 250 billion, making France the euro-area country with by far the highest exposure to the Italian banking sector (amounting to almost 13% of French GDP) (Graph 3.37). Dutch, Austrian and German banks are also significantly exposed, with claims on the Italian banking sector between 3% and 4% of the countries' respective GDPs. Outside the euro area, Switzerland and the United Kingdom were the two most exposed non-euro-area European countries at the end of 2012 (3.6% and 1.8% of their respective GDPs). The exposures of banking sectors in non-European countries are more limited (Japan for 0.7% and the United States for 0.3% of their respective GDPs). Gross foreign claims of Italian banks are mainly towards banking sectors in other European countries: Germany (11.8% of Italian

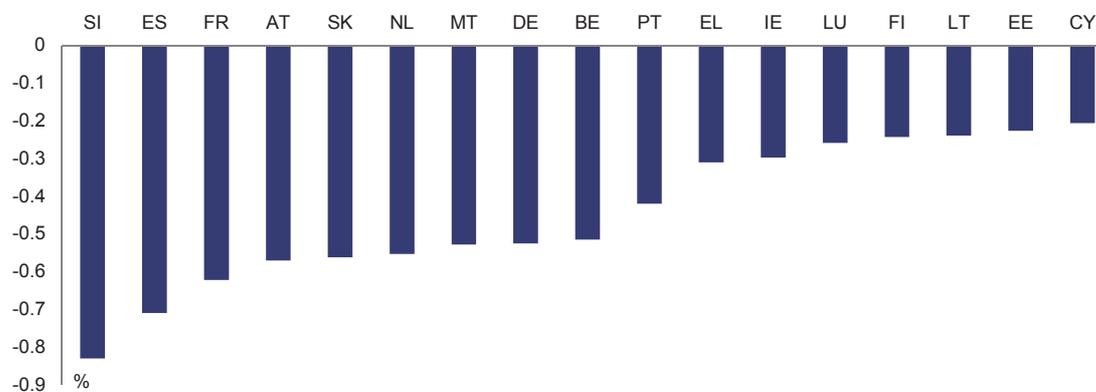
⁽⁴⁷⁾ Istat (2012)

⁽⁴⁸⁾ Accetturo et al. (2013)

⁽⁴⁹⁾ Bloom et al. (2012), Bloom et al. (2007)

⁽⁵⁰⁾ IMF (2013a)

Graph 3.36: Decrease in exports of euro-area countries as a result of 10% decrease in Italian domestic demand

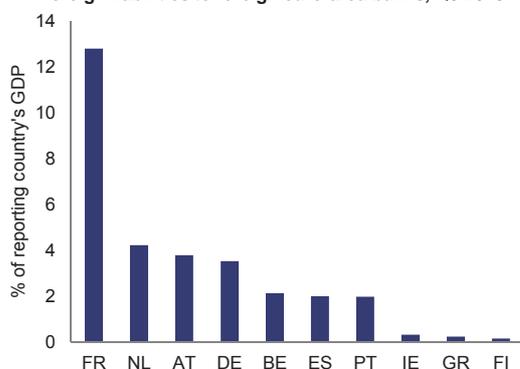


Source: Commission services, WIOD

GDP at the end of 2012), Austria (5%), the United Kingdom (2.5%), Poland (2.4%) and France (2.3%). Non-EU countries account only for roughly one quarter of Italian banks' foreign claims.

partners would be among the most affected countries. In particular, stylized simulation of a 10% decline in Italian domestic demand would lead to export losses well over ½% in Slovenia, Spain and France.

Graph 3.37: Geographical distribution of Italian banks' foreign liabilities to foreign euro-area banks, Q3 2013



Source: Bank of International Settlements

3.4.2. Italy's imbalances and spillovers to the euro area

A fall in domestic demand in Italy adversely affects euro-area partners. Graph 3.36 shows the relative distribution of export losses in euro-area countries associated with sluggish growth in Italian domestic demand (for instance, as a consequence of fiscal consolidation), based on a simulation in an input-output framework using the recent World Input-Output Database (WIOD). ⁽⁵¹⁾ Euro-area

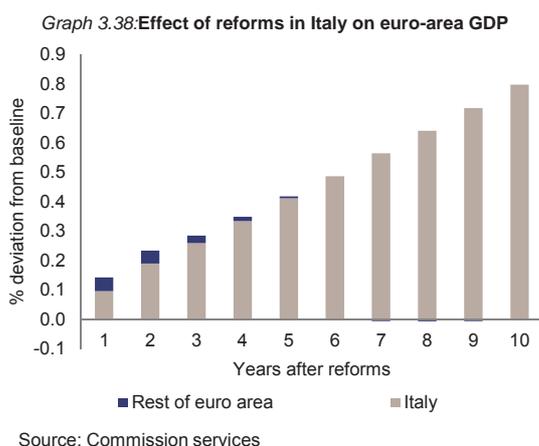
On the other hand, structural reforms to boost productivity and growth in Italy would have positive spillovers on other euro-area countries. Simulations based on the Commission's QUEST III model show that a comprehensive package of growth-enhancing policy measures to bring Italy closer to best practices in the euro area would boost Italy's GDP and could have significant cross-border spillovers to the rest of the euro area, although smaller than those from demand shocks due to offsetting income and competitiveness channels (Graph 3.38). In the short-run, the reforms would increase Italy's domestic demand and increase exports from partner economies, therefore boosting their economies. Countries that would benefit most from reforms in Italy in the first two years would include France, Portugal or Cyprus (Graph 3.39). However, over the longer run, this effect fades away due to relative cost, price and competitiveness position adjustments. The simulations also show that the parallel implementation of ambitious reforms across several Member States would overall imply cross-border spillovers with potential synergetic effects. In Italy, these synergies would lead to an

⁽⁵¹⁾ Such an exercise takes into account the complex inter-sectoral and inter-regional links, which is important to properly assess the extent to which economy activity in one country spills over across borders. On the other hand, this

linear exercise fails to reflect the general equilibrium effects and neglects other transmission channels for cross-border spillovers such as FDI or other financial flows or labour flows.

additional increase in GDP of 0.2%, excluding any direct gains. ⁽⁵²⁾ Therefore, reforms that enhance productivity and competition in Member States would benefit the entire euro area.

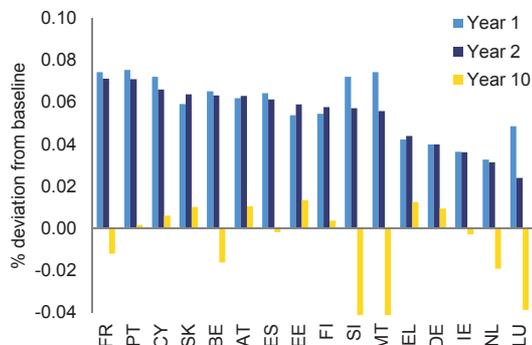
Italy's high public indebtedness could exert adverse effects on euro-area countries. The transmission channel here is financial markets' sentiment and confidence. The high debt level and the challenge for the government to put it on a downward path in a context of low growth could create market uncertainty in case of fiscal adjustment fatigue and/or further delayed reform action. Markets may fret and spreads thereby widen again, as happened in 2011 at the height of the sovereign debt crisis. Since then, the Italian government has however shown its willingness to pursue fiscal consolidation, and yields have decreased significantly. Recent analyses of determinants of sovereign spreads in the euro area ⁽⁵³⁾ ascribe indeed an important role to the increase in general risk perception which particularly affected the group of vulnerable euro-area economies, including Italy. This can be seen in Graph 3.40 which shows the share of variance in sovereign spreads in several euro-area countries accounted for by a common factor. Following the establishment of the European Financial Stability Facility (EFSF) and particularly the announcement of OMT, the co-movement in spreads declined and Italian spreads progressively declined.



⁽⁵²⁾ Varga et al. (2013)

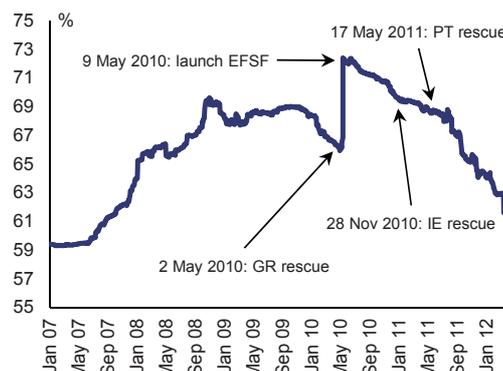
⁽⁵³⁾ See for instance Giordano et al. (2012)

Graph 3.39: Spillovers of structural reforms in Italy on other euro-area members



Source: Commission services

Graph 3.40: Variance in sovereign spreads explained by a common factor



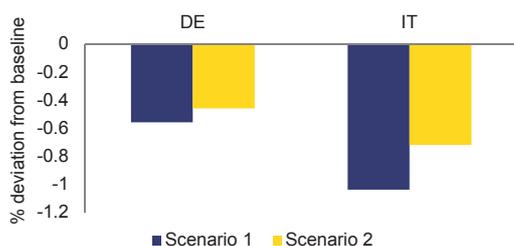
Source: Commission services

3.4.3. Macroeconomic developments in the euro area and adjustment in Italy

Modest growth and prolonged low inflation in the rest of the euro area make the adjustment in Italy more challenging. Sluggish demand in Italy's main trade partners, driven by both simultaneous fiscal consolidation in several other euro-area countries and adjustment of excessive private indebtedness, makes Italy's turnaround in export performance more difficult. This is further strengthened by zero-lower-bound constraints on euro-area monetary policy to counter deflationary pressures and to prop up economic activity. Furthermore, a prolonged period of inflation substantially below the ECB's medium-term target of below-but-close-to 2% also in non-vulnerable euro-area countries would reduce the room for price adjustment to recover competitiveness and make the reduction of Italy's debt-to-GDP ratio more challenging (see Section 3.1).

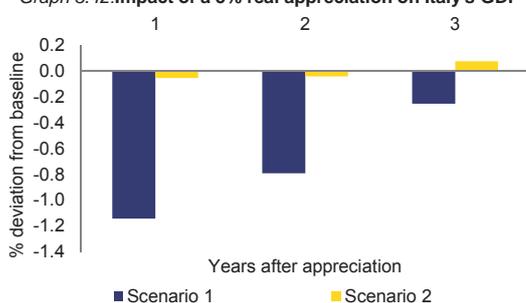
The asymmetric adjustment within the euro area and the resulting euro-area wide current account surplus could lead to an appreciation of the euro exchange rate. Such an appreciation could have a detrimental effect on intra-euro-area imbalances. The simulations with the QUEST III model show that a sizeable real effective appreciation of the euro would lead to a decline in Italian exports and also output (Graphs 3.41). The effects of an appreciation induced by internal euro-area factors, e.g. due to a reduction in risk perceptions (Scenario 1 in Graph 3.42), would be bigger than those originating from outside, e.g. as a result of monetary easing in the US and Japan, (scenario 2) as in the latter case domestic demand and imports in the US and Japan would increase, inducing higher demand for euro-area exporting firms.

Graph 3.41. First-year impact of a 5% real appreciation on Italy's exports



Source: Commission services
 Note: Scenario 1 = 5% euro REER appreciation due to a reduction in risk premia in the euro area vis-à-vis the rest of the world. Scenario 2 = 5% euro REER appreciation due to a monetary policy loosening in the United States and Japan.

Graph 3.42. Impact of a 5% real appreciation on Italy's GDP



Source: Commission services
 Note: Scenario 1 = 5% euro REER appreciation due to a reduction in risk premia in the euro area vis-à-vis the rest of the world. Scenario 2 = 5% euro REER appreciation due to a monetary policy loosening in the United States and Japan.

4. POLICY CHALLENGES

Restoring dynamic and sustainable growth remains the key challenge to reduce Italy's macroeconomic imbalances and the risks they imply. As highlighted in this report, Italy's growth over the last fifteen years has been disappointing and has contributed significantly to the emergence of the two identified macroeconomic imbalances: the high level of public indebtedness and the loss of external competitiveness. Improving productivity is the first-best policy avenue. However, the structural reforms required may take considerable time to bear fruit. This suggests the possible need for complementary measures with short-term impact.

Debt sustainability

Maintaining high primary surpluses over an extended period is a condition *sine qua non* for the reduction of the high public debt-to-GDP ratio. Thanks to the recent fiscal adjustment effort, Italy managed to regain some investor confidence, lower the country risk premium and reap the 'stability dividend' of progress made at European level in strengthening the economic governance architecture. Going forward, concerns about the sustainability of Italy's high public indebtedness in a context of chronically weak potential growth may re-ignite tensions in financial markets. Sustaining fiscal discipline by reaching the medium-term objective (MTO) of a balanced budget in structural terms and achieving and maintaining sizeable primary surpluses would help to put the debt-to-GDP ratio on a steadily declining path and preserve investor confidence.

Structural reform momentum

Given the magnitude and variety of challenges facing the Italian economy, setting out a clear reform agenda with detailed timelines and ensuring the full implementation of measures taken is a matter of urgency. Italy has for too long postponed much-needed structural reforms. The abated financial-market pressures in recent months and the gradually improving economic outlook cannot leave room for complacency. It appears therefore crucial that the sluggish and at times ineffective implementation of approved measures is tackled. It seems also essential that reform momentum is regained. Setting out a comprehensive reform agenda, indicating priorities

and milestones, would maximise policy synergies. At the same time, ensuring a fair distribution of the burden of adjustment appears to be a priority.

Swift and robust action to remove barriers to the efficient allocation of resources would foster competitiveness and growth. Removing remaining barriers to competition and addressing long-standing inefficiencies in public administration and the judicial system, also through the effective implementation of measures taken, would be crucial to remove obstacles to efficient resource allocation within the economy. It would also support the creation of new (innovative) firms and enhance Italy's export capability, thereby contributing to a dynamic and sustainable growth. Italy would also benefit from improving tax compliance, reducing the shadow economy and fighting corruption. Furthermore, there is significant room to modernise corporate governance structures, both among publicly-controlled enterprises and private-sector firms, which are often family-managed.

Investment and human capital

Future productivity growth will not only depend on the quantity but also the quality of investment. The observed pattern of capital accumulation has not gone hand-in-hand with dynamic productivity growth, while technology absorption and innovation capacity remained low. The crisis led to a rapid fall in investment. While demand prospects are slowly improving, restoring the flow of credit to the real economy is important. Promoting the further development of capital markets – in particular equity markets – would also help to improve the allocative efficiency of the financial system and support productivity-enhancing innovation. Attracting more FDI would allow the Italian productive system to take advantage of transfers of knowledge and technology - enabling product and process innovation - and would encourage modern corporate governance structures.

Barriers to the efficient allocation of labour and accumulation of human capital need to be removed. Further addressing labour market segmentation and allowing wage differentiation to better reflect productivity and local labour market conditions would improve the allocation of labour

within and across firms and sectors and provide the correct market incentives for human capital investment. The education system could be made more inclusive and conducive to a smoother transition to the labour market. Enhancing work-based learning and high-quality vocational training would also be beneficial.

Restoring cost competitiveness

Labour cost moderation and a reduction in the tax wedge on labour would have positive effects on Italy's external cost competitiveness. In anticipation of the materialisation of the beneficial effects of structural reforms on productivity and growth, measures to alleviate pressures emanating from the cost side could support external competitiveness already in the short term. Further improvements to the collective bargaining framework to make wages more responsive to productivity and local labour market conditions could be explored, while closely monitoring the potential emergence of harmful deflationary pressures and social distress. A decisive strategy to shift taxation away from productive factors in a budgetary neutral manner and reduce Italy's high labour tax wedge would equally help to moderate labour cost pressures, while making the tax system more growth-friendly. In addition, simplifying tax compliance and administrative procedures could also assist in reducing the high cost of doing business and support external competitiveness.

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