MEF Dipartimento del Tesoro

Relevant Factors Influencing Public Debt Developments in Italy

May 2018

Ministero dell'Economia e delle Finanze

INDEX

EXECUTIVE SUMMARY

- Italy's public finances continued to improve in 2017, as the general government deficit declined to 1.9 percent of GDP (excluding banking sector support measures), from 2.5 percent in 2016. The deficit is projected to further decline to 1.6 percent of GDP this year and, under existing legislation, to 0.8 percent in 2019 and zero in 2020, turning into a 0.2 percent-of-GDP surplus in 2021.
- According to the latest data from the statistical office (ISTAT), the budgetary impact of government interventions in the banking system that were carried out in 2017 (recapitalization of Banca Monte dei Paschi di Siena and mandatory liquidation of Veneto Banca and Banca Popolare di Vicenza) was 0.4 percent of GDP (which led to the 2017 headline deficit being revised up to 2.3 percent in the final release), while the overall impact on gross public debt is just under 1.0 percent of GDP.
- However, it must be emphasized that: a) the interventions were a one-off event; b) the actual cash disbursement was equivalent to 0.6 percent of GDP in total; c) the deficit impact estimated by the statistical authorities consists of *unrealised losses*; d) the debt increase over and above the cash disbursement reflects government guarantees provided in the winding up of the two Veneto banks, i.e. *contingent liabilities*.
- The general government debt-to-GDP ratio in 2017 declined to 131.8 percent, from 132.0 percent in 2016. Excluding the one-off banking sector interventions, it would have fallen to 130.8 percent. If only the actual cash disbursements for such interventions had been included, it would have registered a 131.4 percent level.
- The official estimates of nominal GDP for 2016 and 2017 are preliminary and may be revised up, as was the case for 2014 and 2015 when final figures became available. Final GDP data are released at Y+2, which means that, for instance, the final 2016 figures will only be released in September 2018. Higher nominal GDP would lead to a downward revision in the debt ratios.
- At any rate, the Stability Program that was recently delivered to Parliament projects a decline in the debt ratio under existing legislation to 130.8 percent of GDP this year, 128.0 percent in 2019, 124.7 in 2020 and 122.0 in 2021. On a longer view, if the cyclically adjusted primary surplus remains at the level projected for 2021 (3.6 percent of GDP), the debt ratio will fall below 100 percent of GDP by 2030.
- According to official estimates, the cyclically adjusted budget balance net of one-off measures (structural balance) in 2017 worsened to -1.1 percent of GDP, from -0.9 percent of GDP in 2016. It is projected to improve to -1.0 percent this year and -0.4 percent in 2019, before turning into a surplus of 0.1 percent of GDP in 2020 and 2021.
- This projection is based on GDP growth of 1.5 percent in real terms and 2.9 percent in nominal terms in 2018. Real GDP growth is expected to subsequently slow to 1.2 percent by 2021, while nominal growth would accelerate in 2019 and 2020, due also to the impact of projected increases in indirect taxes on the GDP deflator.

- In fact, the 2018 Budget envisages increases in indirect taxes worth 0.7 percent of GDP in 2019 and a further 0.4 percent in 2020. This fiscal tightening can only be changed via new legislation and any revisions of structural deficit targets compared to the 2018 DBP would have to be consistent with national and European fiscal rules.
- Even though the public debt ratio declined in 2017, the debt criterion was not satisfied in any of the three configurations envisaged in the Six Pack and in its national transposition (Law 243, December 2012). In accordance with Article 126(3) of the TFEU, whenever a member state appears to have exceeded the reference values, the Commission is expected to prepare a report identifying "all other relevant factors" that should be considered when assessing compliance with budgetary discipline. In response to a request from the Commission, the present document puts forth and discusses a series of factors that "are relevant in order to comprehensively assess in qualitative terms the excess over the reference value."
- The first factor discussed herein is Italy's consistent track record of fiscal discipline, witnessed by sizable primary surpluses (1.6 percent of GDP on average in 2013-2016 and 1.9 percent in 2017, excluding the one-off deficit related to banking sector interventions) and a remarkable moderation in current primary expenditure *in nominal terms* (average growth of 1.0 percent in 2011-2016 and only 0.4 percent in 2017). Current primary expenditure has fallen from 42.8 percent of GDP in 2013 to 40.7 percent in 2017.
- The second is that, given the flexibility margins that were agreed with the Commission for the 2015-2017 period, Italy was fully compliant with the preventive arm of the Stability and Growth Pact in 2015 and 2016. It was also compliant in 2017 on an annual basis, while the two-year average was slightly above the allowed 0.25 percentage point deviation. However, the expenditure rule was fulfilled in 2017 too.
- Thirdly, it must be recognized that the debt-reduction rule is excessively demanding in conditions of near deflation and for a country that needs to regain wage and price competitiveness within a monetary union — especially if other member countries characterised by excessive surpluses continue to experience low inflation.
- Consumer price inflation in Italy rose in 2017 after two years of near-deflationary conditions, but this was entirely due to a recovery in energy and commodity prices. Growth in Italy's deflator continued to slow, and that led to moderate nominal growth even though economic activity picked up in real terms and industrial production rose by 3.7 percent. All inflation gauges, from wages to hourly labour costs, from consumer prices to core inflation, suggest that Italy is still subject to greater deflationary pressures than other Euro area countries.
- The fourth factor has to do with the measurement of slack in the economy. Italy has regained wage and price competitiveness vis-à-vis the European average and its main trading partner, Germany. According to Eurostat, in 2017 Italian average hourly labour cost was equal to 82.7 percent of Germany's level, down from 90.8 percent in 2012. However, this recovery in cost competitiveness is the result of continuing slack in the labour market and in the economy at large. Italy's unemployment rate, at 11.0 percent, is more than three times Germany's rate (3.4 percent). Before the crisis and until 2008, Italy's unemployment rate was lower than Germany's.

- In the Spring Forecast 2018 the Commission revised Italy's output gap in line with country-specific technical changes that were proposed by our delegation to the Output Gap Working Group and approved by the Economic Policy Committee. Compared to the Autumn Forecast, Italy's 2017 gap has widened from -0.6 percent to -1.2 percent of GDP, and the 2018 one from +0.3 to -0.1 percent of GDP. However, the Commission's revised estimates still suggest that Italy's GDP has reached its potential. On the contrary, high unemployment and the virtual absence of domestic inflationary pressures point to still-ample slack in the economy.
- In Chapter IV of the present report, we expand the analysis presented in the previous edition (February 2017) and show that, with relatively limited technical changes to the commonly agreed methodology for estimating potential output, Italy's output gap over the past few years would have been significantly wider than suggested by either the Commission's or Italy's official estimate. In 2017, the gap would still have been as wide as -3.8 percent of GDP, and this year it would be -2.8 percent of GDP.
- With these – in our view more realistic – output gap estimates, Italy's structural budget balance would have been zero in 2016 and -0.2 percent in 2017. Regardless of flexibility margins granted by the Commission, Italy would have broadly achieved its Medium Term Objective (of a balanced structural budget) in both of the past two years and it would remain in that position in 2018. In 2019, a 0.2 percentage point improvement would be sufficient to fully achieve the MTO.
- The importance of output gap estimates in European fiscal rules is such that, using the alternative output gap estimates and assuming a growth rate in the GDP deflator of 2 percent, in 2017 Italy would have satisfied the debt rule in the cyclically-adjusted configuration, outperforming the benchmark by 1.4 percentage points. Excluding the one-off intervention in the banking system, the distance from the benchmark would have been an even more compelling 2.4 percent of GDP.
- The fifth factor put forth and analysed in this report is debt sustainability. Based on the latest Commission estimates, Italy's S1 sustainability indicator signals a high risk. On a longer view, revisions to demographic and economic growth projections in the 2018 Ageing Report imply a downgrade of the S2 indicator to a medium level of risk, from the low risk signaled by the previous edition of the Ageing Report (2015). We show that with alternative potential growth estimates and maintaining the original fifteen-year horizon for the computations, Italy's S1 would signal a medium, not a high risk level. Furthermore, using the national scenario for age-related expenditures (which relies on Istat demographic projections), the S2 indicator continues to point to a low long-term risk, thanks also to the medium and long term impact of past pension reforms.
- A further factor is the affordability of public debt: interest payments in 2017 fell to 3.8 percent of GDP, and should reach 3.5 percent this year. In 2017 their ratio to total government revenues also fell to the lowest point in decades, 8.2 percent, and is projected to decrease further to 7.6 percent this year.
- Another aspect to consider is contingent liabilities. According to Eurostat figures, Italy has one of the lowest levels of government guarantees in the EU. The latest data are for 2016, but even with the guarantees provided as part of the banking sector interventions in 2017, contingent liabilities remain low on a comparative basis. In addition, Italy's private sector debt is low, especially household debt. Property prices

have not yet bottomed out after a sharp drop in 2011-2014. Banks have been recapitalized and their NPL ratios, though still high, continue to decline. Latent risks for the public finances thus appear contained.

- Finally, Italy's structural reform effort should also be taken into account. Further progress on reforms was made in 2017, especially on healing and restructuring the banking system, improving tax collection and enhancing competition in services. The effect of approved reforms is still in progress, this being particularly evident in the case of the banking sector, where NPLs are declining at a rapid pace. The positive growth impact of structural reforms carried out in the 2014-2017 period is estimated at 2.2 percentage points of GDP by 2020, 3.4 points by 2025 and 8.2 in the long run.

I. RECENT BUDGET AND DEBT PERFORMANCE

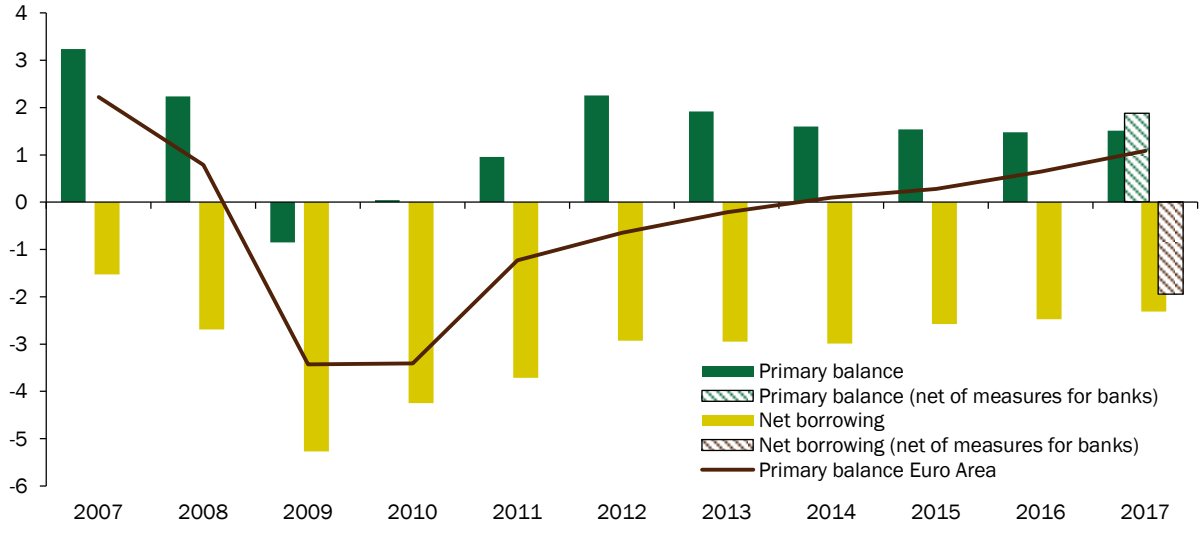
I.1 RECENT BUDGET AND DEBT PERFORMANCE

Italy's general government deficit declined to 2.3 per cent of GDP in 2017, from 2.5 per cent in 2016. The improvement in the budget was even greater excluding the effects of a one-off intervention to support the banking system, which was worth 0.4 percent of GDP. The decline in the deficit was achieved thanks not only to the measures contained in the 2017 Budget, but also additional deficit-reducing measures worth 0.2 percent of GDP that were implemented in May in response to a recommendation from the European Commission.

Net of the bank support measures, the 1.9 percent-of-GDP deficit recorded in 2017 is lower than the 2.1 percent estimate featured in last year's Stability Program (which included the effects of the 0.2-percent-of-GDP supplemental package). It is also worth noting that the actual cash disbursements related to the aforementioned banking system interventions are financial transactions and, as such, are not included in the ESA 2010 deficit figures. The costs included in the headline deficit consist of *unrealised* losses that Istat, Italy's statistical office, decided to include in its official deficit notification in early April based on an opinion from Eurostat.[1]

The primary surplus in 2017 remained steady at 1.5 per cent of GDP, but it actually improved to 1.9 per cent of GDP excluding the bank support measures), vis-à-vis an average primary balance of about 1.1 per cent in the Euro Area.

FIGURE I.1 – GENERAL GOVERNMENT DEFICIT AND PRIMARY BALANCE, EDP (% of GDP)



Source: ISTAT and AMECO database.

[1] The statistical office adopted an alternative estimate of assets and liabilities acquired by government as a result of the orderly liquidation of Veneto Banca and Banca Popolare di Vicenza. This yielded in an estimated net loss of €4.7 billion. In addition, it estimated a net loss of €1.6 billion from the precautionary recapitalisation of Banca Monte dei Paschi di Siena.

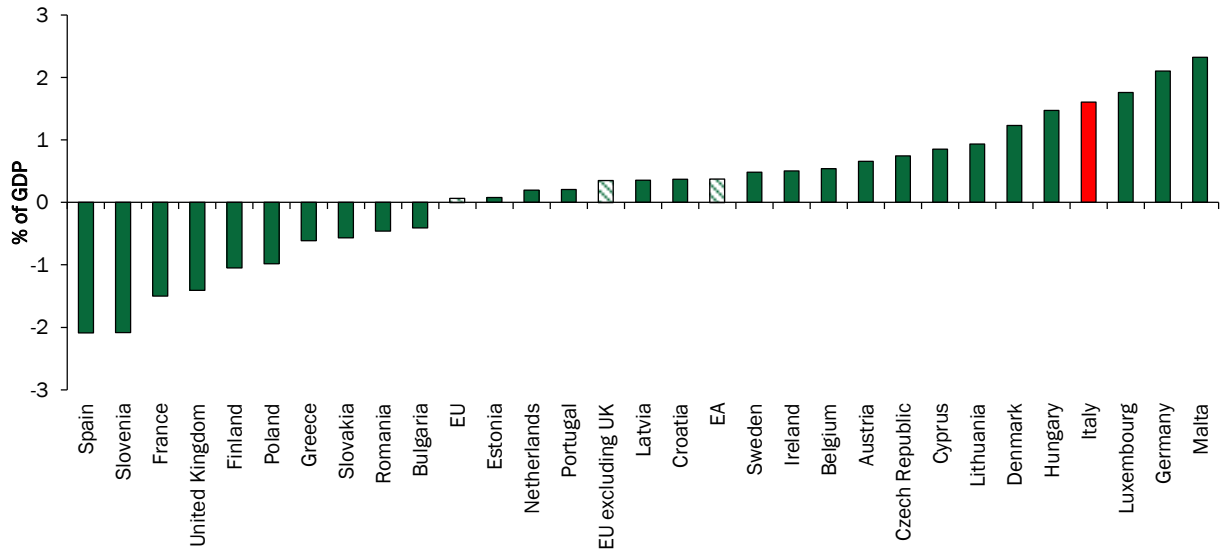
As stressed in previous Italy's Reports on relevant factors, since the economic and financial crisis, fiscal consolidation has been a central feature of Italy's budget policy via the maintenance of positive primary balances in spite of the sharp drop in GDP. Italy has recorded one of the largest primary surpluses in the Euro Area and the European Union over the past five years (1.6 per cent of GDP, as shown in Fig. I.2). In the period 2013-2017, both the Euro Area and the European Union recorded a primary deficit of 0.4 per cent of GDP.

The 2018 Commission Spring Forecast projects the Italian primary surplus to improve to 1.9 percent of GDP in 2018 and slightly reduce to 1.7 per cent next year. The deficit-reducing effects of the VAT hike envisaged by the 2018 Italian Budget Law (effective January 2019), which are worth 0.7 percentage points of GDP, are not included in the no-policy change assumptions underlying the Commission forecasts. Nonetheless, the forecasts confirm the soundness of Italy's position vis-à-vis other European partners. The primary balance in the Euro Area is forecast below 1.2 percent in both 2018 and 2019.

The attainment of significant primary budget surpluses has contributed to the stabilisation of the debt-to-GDP ratio in the last three years. The ratio of public debt to GDP declined to 131.8 per cent in 2017 (the second decline after the one recorded in 2015). The outturn for 2017 was initially estimated at 131.5 per cent of GDP, but was revised up in the Notification to Eurostat at the end of March due to the recording of the winding down of the two Veneto banks, which entailed the inclusion of the Liquidator's liabilities towards Intesa San Paolo as part of the general government gross debt (indirect impact worth €6.4 billion).

Due to this statistical treatment, the impact on public debt of the transactions on the two Veneto Banks was estimated at €11.2 billion, while the whole impact of actions taken for the Veneto Banks and BMPS rose to about €16.6 billion (close to 1 percent of GDP). Consistent with the public debt forecast reported in the Stability Program Update of last September and in the 2018 DBP, the direct impact on the net borrowing requirement was confirmed at €10.2 bn.

FIGURE I.2 – GENERAL GOVERNMENT PRIMARY BALANCE, EDP (average 2013-2017)



Source: AMECO database.

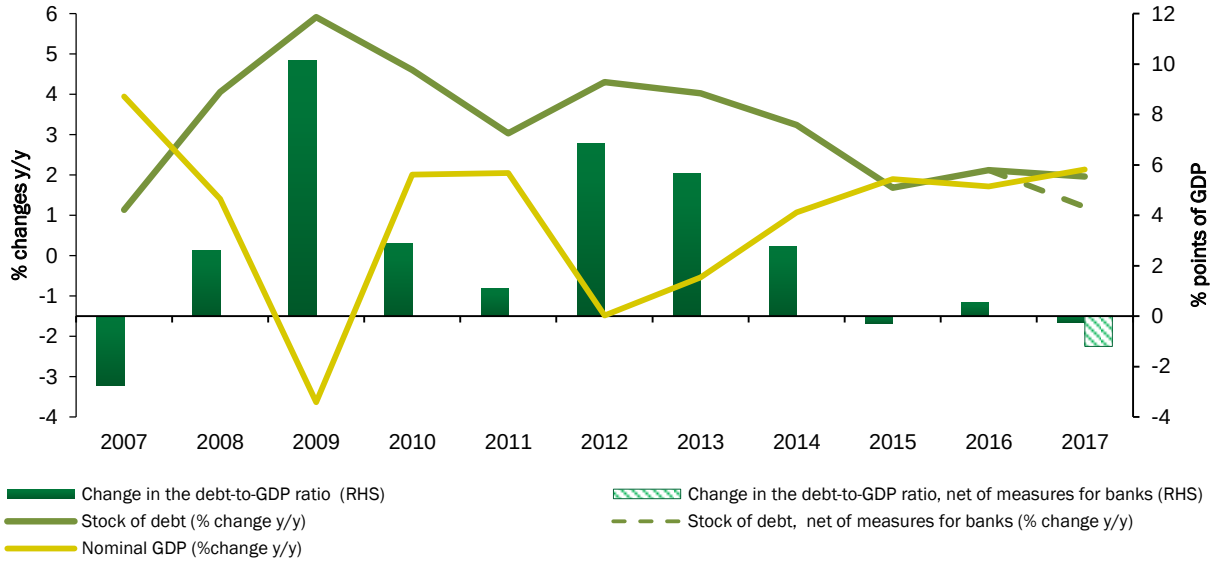
Given that nominal GDP growth (2.1 percent) is fully in line with official forecasts from last autumn, the slightly higher debt-to-GDP ratio compared to the 131.6 percent projection in the 2018 DBP is exclusively due to the statistical classification of these measures. Excluding the impact of about 1 percentage point of GDP of the intervention in the banking system, the debt-to-GDP ratio would have declined by 1.2 percentage points in 2017 (see Fig. I.3).

Underlying the maintenance of high primary surplus in 2017 there is an improvement in the quality of public finance, which is expected to continue in the coming years. In 2017, both revenues and primary spending as a share of GDP declined by about 0.3 percentage points, yielding a diminishing tax burden (from 42.7 to 42.5 per cent) and primary expenditure-to-GDP ratio (from 45.4 to 45.1 per cent).

On the revenue side, the measures introduced have aimed at minimizing the distortionary impact on economic growth. As a result of budget measures already legislated, taxes deemed detrimental for the economy were reduced and are projected to further decrease. As pointed out in the Economic Policy Committee meeting of last November 2017 on benchmarking the tax burden on labour, Italy continued to make progress in reducing the tax wedge on labour for low wages (50 per cent of average). The cut in the corporate income tax rate (from 27.5 to 24 percent) contributed to the decrease in the ratio of current taxes on income and wealth to 14.6 percent of GDP in 2017, while the entry into force as from 2018 of an optional substitute 24 percent proportional tax rate, named IRI, equal to the corporate income tax rate to be applied to SMEs, partnerships, sole proprietorships, self-employed workers, artisans and professionals on re-invested income instead of PIT rates will contribute in reducing direct taxes.

The more dynamic trend recorded by indirect taxation in 2017 befitted from the extension of the split payment mechanism on VAT and measures introduced to increase VAT compliance, such as stricter rules on VAT deductions and offsets, as well as the increases in taxation of lotteries, betting and tobacco. Revenue from social contributions is projected to decrease as a share of GDP, mainly due to the measures enacted in the 2018 Budget Law (reduction of employer contributions on new permanent contracts for under-34s).

FIGURE I.3 – KEY DRIVERS OF GENERAL GOVERNMENT DEBT, EDP (% changes y/y and % points of GDP)



Source: ISTAT.

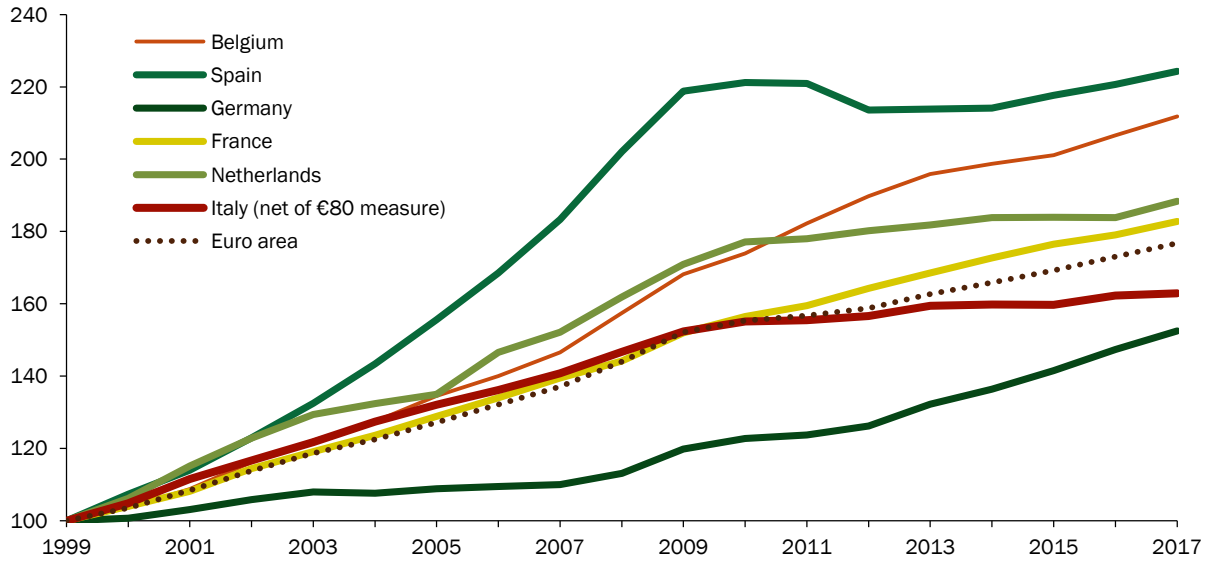
The corrective arm of the SGP explicitly mentions the development of primary expenditure, both current and capital, as a relevant factor to be considered for the purpose of the Excessive Deficit Procedure (Art. 3, of Regulation 1467/1997).

As already stressed in previous Italy's reports on Relevant Factors, the soundness of Italy's primary surplus was supported by the stabilisation of primary expenditure, and especially of the current expenditure component. General government current spending excluding interests declined from 42.0 percent of GDP in 2016 to 41.3 percent in 2017 and is forecast to decline to less than 41 percent of GDP in 2019, according to both the 2018 Commission Spring Forecast and Italy's latest trend projections. The stabilisation of Italy's primary current spending would be even more pronounced if the €80 monthly rebate in favour of salaried workers with an annual income of less than €25 thousand,[2] which was introduced in 2014 and became permanent in 2015, was classified as a lower tax rather than a social transfer.

In 2017, compensation of public-sector employees only increased by 0.1 percent y/y in nominal terms compared with the 1.1 per cent increase in 2016. The increase in intermediate consumption was 2.6 percent y/y, while social transfers in cash increased by 1.7 per cent y/y, a lower rate of GDP. As a result, the 0.4 percent y/y increase in current primary spending was lower than nominal GDP growth and the ratio of primary current spending to GDP remained on a decreasing path and below those of the Euro Area.

Public investment in 2017 did not increase as planned, despite the efforts made by Italian authorities to bring public capital accumulation back towards pre-crisis levels, including via additional funds for areas hit by earthquakes, the establishment of an *ad hoc* investment fund for infrastructural development and supplementary resources for regions and local entities.

FIGURE I.4 - GENERAL GOVERNMENT PRIMARY CURRENT EXPENDITURE (LEVEL, 1999= 100)



Source: Elaboration on AMECO data. For the €80 measure data from Italy's MEF, Department of Finance.

[2] The pre-tax income ceiling to benefit from the measure was initially €26,000 (with a reduced benefit) and was recently revised to €26,600. The full benefit was initially received up to €24,000 of pre-tax income, later raised to €24,600.

The sluggishness of investment activity is not just an Italian issue but, according to recent literature, it is one of the main causes of the unsatisfactory economic recovery in the main industrialised economies that are facing lowering standards in their infrastructural assets after years of investment retrenchment due to austerity measures. According to Italian government trend projections, starting from 2018 there will be a turnaround for government gross fixed capital formation, thanks also to the full implementation of reforms that may have initially slowed investment decisions at the local level, such as the new Public Procurement Code.

The recovery of public investment in Italy should be encouraged by European fiscal rules in the future years. Government investment has the highest estimated impact on GDP, with a multiplier above 1 in the current situation characterised by interest rate at the zero lower bound.

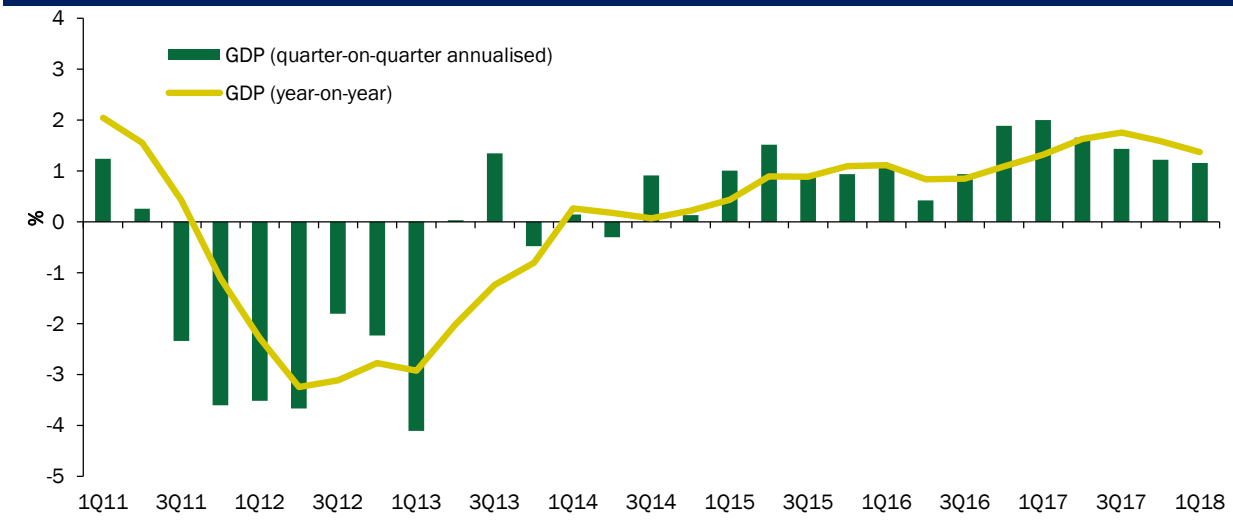
Finally, the 2018 Budget implemented the integration of the spending review process into the budget cycle. Ministries were directly involved in the spending review in order to achieve savings consistent with the overall expenditure-reduction target. These proposals, which are worth €3.0 billion over the 2018-2020 period, were included in the 2018 Budget.

II. MACROECONOMIC CONTEXT

II.1 LOWFLATION AND COMPETITIVENESS

Economic conditions in Italy improved in 2017, as real GDP growth picked up to 1.5 percent, from around one percent in the previous two years. Employment grew by 1.1 percent, and the unemployment rate fell to 11.2 percent, from 11.7 percent in 2016.

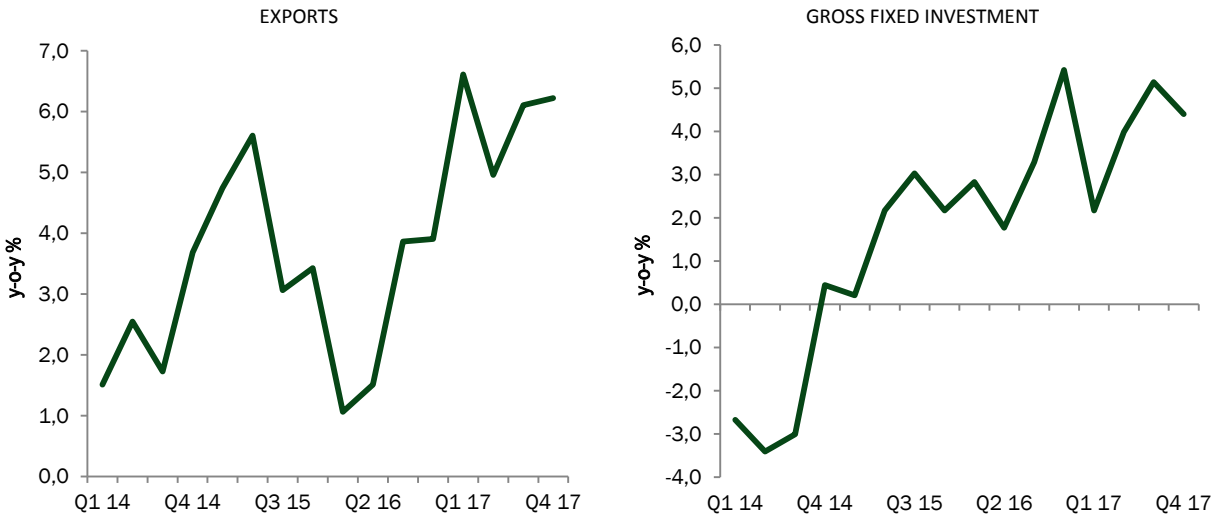
FIGURE II.1 – ITALY'S REAL GDP GROWTH



Source: ISTAT.

Gross fixed investment (GFI) and exports drove the acceleration in real GDP growth in 2017, as GFI grew by 3.7 percent (from 3.2 percent in 2016) and exports of goods and services rose by 5.4 percent, up from 2.4 percent in 2016.

FIGURE II.2 – EXPORTS AND GROSS FIXED INVESTMENT GROWTH



Source: ISTAT.

The net foreign trade contribution to growth was of 0.1 percentage points, as import growth also picked up to 5.3 percent, from 3.5 percent in 2016. The growth contribution of domestic final sales was of 1.5 percentage points, as household consumption grew by 1.3 percent (slightly down from 1.4 percent in 2016) while inventories subtracted around 0.2 points from annual growth.

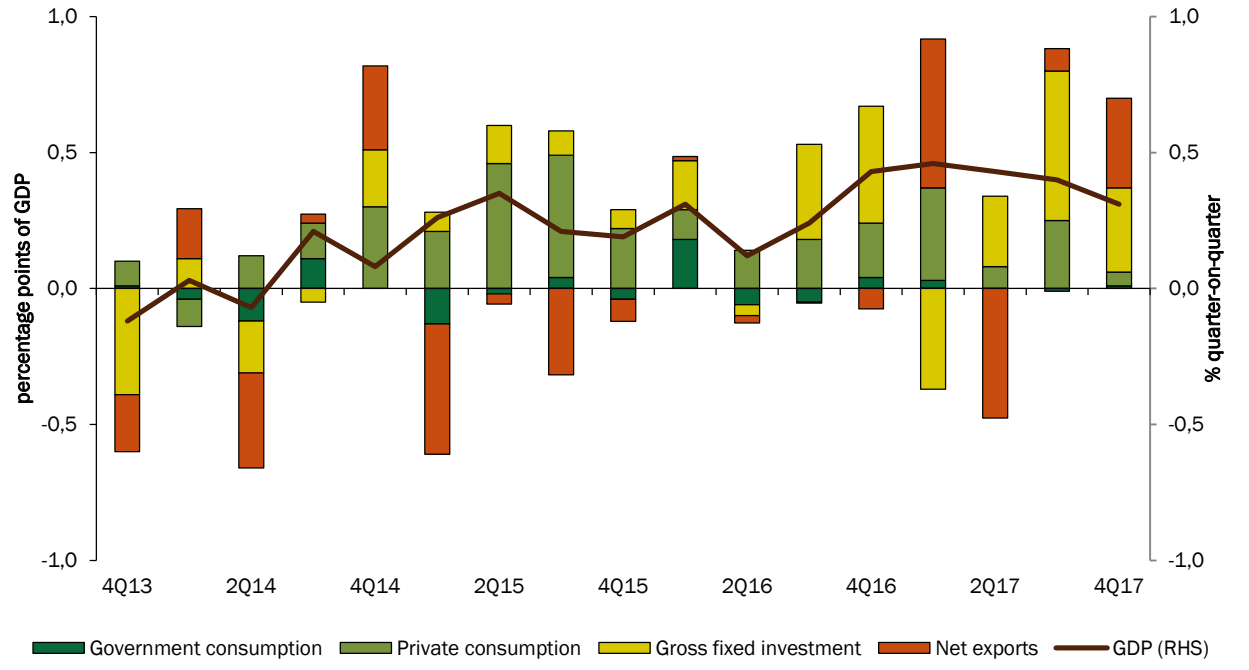
The growth pattern that has emerged since the crisis and especially in 2017 represents a desirable adjustment process in an economy that needs to regain competitiveness within a monetary union. As noted above, growth has been led by exports and investment, accompanied by wage moderation, improving competitiveness and a widening current account surplus (2.8 percent of GDP, from 2.6 percent in 2016).

However, this type of adjustment implies that, given unrelenting global competitive pressures and a still-high degree of slack in the economy, Italy continues to experience very low inflation. In turn, this entails low nominal GDP growth, which slows down the decline in the public debt-to-GDP ratio in spite of a primary budget surplus that is among the highest in the EU.

According to preliminary national accounts data for 2017, growth in the GDP deflator in 2017 slowed to 0.6 percent, from 0.8 percent in the previous year. As a result, nominal GDP growth was 2.1 percent, up from 1.7 percent in 2016 but still well below the implied cost of funding of the general government sector (3.0 percent).

Slower GDP deflator growth in a year when consumer price inflation recovered (to 1.3 percent, from zero in 2016) is explained by the fact that the only inflationary impulse came from oil and commodity prices. Given that most commodities are imported, their price increase raises input costs for Italian firms. To the extent that firms are unable to pass on the increase to their customers, and/or view it as transient, inflation in output prices may decline even as costs rise.

FIGURE II.3 – CONTRIBUTIONS TO QUARTER-ON-QUARTER GDP GROWTH



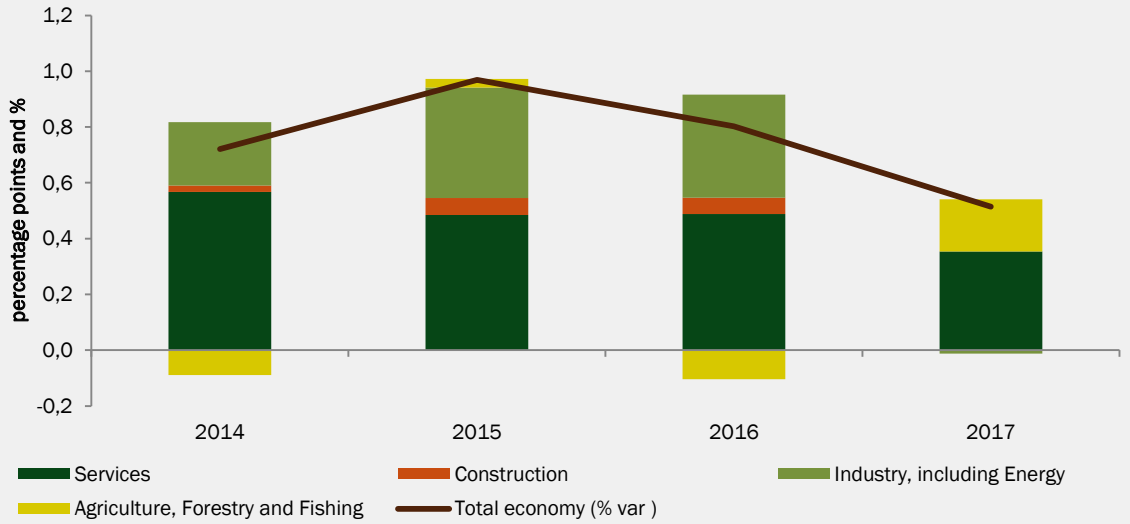
Source: ISTAT.

FOCUS

Value added deflator dynamic

Considering the contribution of each sector to the value added deflator growth, in 2017, compared to the previous years, the manufacturing sector provided a null contribution while the services was weaker, compensated in part by the positive growth in the value added deflator of agriculture, forestry and fishing sector.

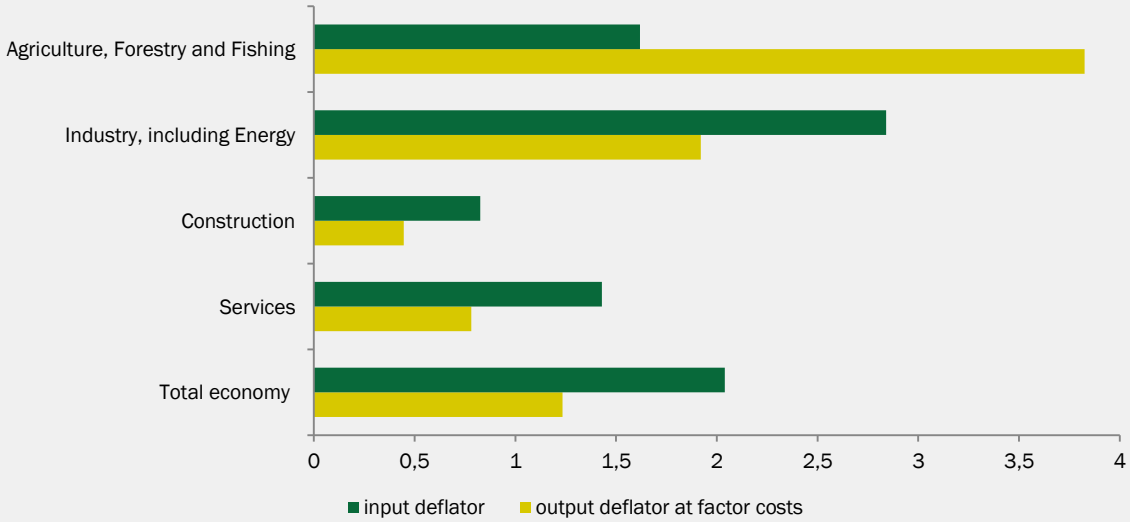
FIGURE R.1 – VALUE ADDED DEFLATOR (SECTORAL CONTRIBUTION TO GROWTH)



Source: ISTAT.

The value added deflator is the result of the difference between input prices (raw materials, energy, goods and services that are intermediate inputs of the production process) and the production prices. In 2017 the growth of input prices was greater than the dynamic of output prices with the exception of agriculture. In the industrial sector this difference is about one percentage point and it explains the null contribution to value added deflator growth. Input prices in the industrial sector are higher than the output ones reflecting stronger commodity prices. This dynamic was not completely passed through the output prices for two main reasons: i) to reduce the negative impact on the domestic demand; ii) to gain market shares. Overall, the industrial mark-up resulted lower in 2017.

FIGURE R.2 - SECTORAL INPUT AND OUTPUT PRICES IN 2017

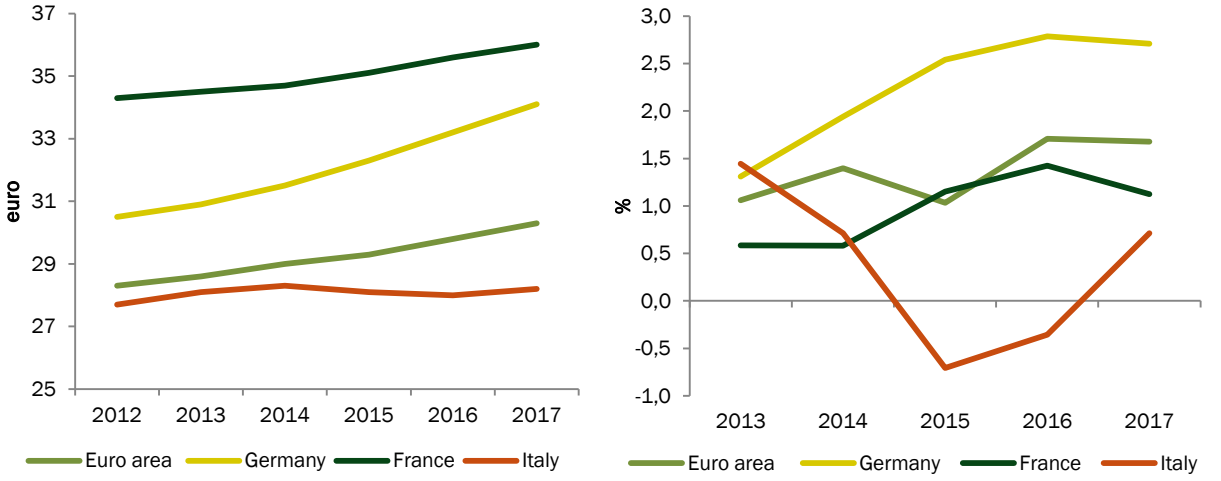


Source: ISTAT.

A comparison with other Euro area countries shows that since 2012 the decline in output price inflation in Italy has been more pronounced and that in 2017 Italy bucked the European tendency towards higher output prices. In fact, inflation in Italy is lower than in the other large Euro area economies across all key wage and price indicators:

- Italy's average hourly labour costs in 2017 grew by 0.8 percent, versus 1.9 percent in the Euro area and 2.6 percent in Germany. As a result of extremely slow growth over the previous five years, Italy's hourly labour cost level in 2017 was 82.7 percent of Germany's level, down from 90.8 percent in 2012 – an eight percentage point competitiveness gain.

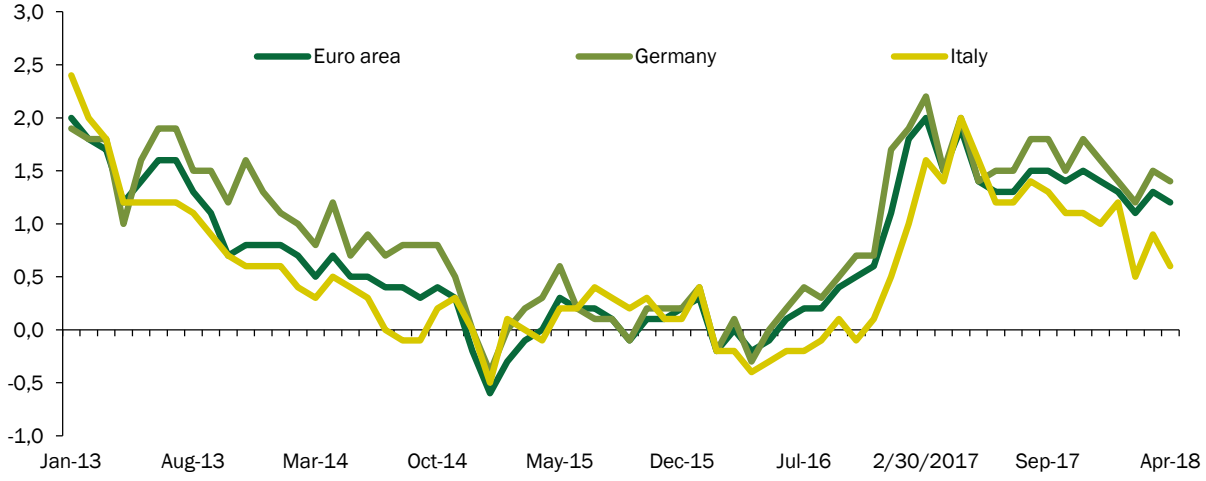
FIGURE II.4 – HOURLY LABOUR COST FOR THE WHOLE ECONOMY (EXCLUDING AGRICOLTURE AND PUBLIC ADMINISTRATION) IN ENTERPRISES WITH 10 OR MORE EMPLOYEES



Source: EUROSTAT.

- Harmonised inflation in 2017 in Italy remained lower than in Europe, at 1.3 percent for the headline index and 0.8 percent for the core index, versus 1.5 percent and 1.0 percent, respectively, in the Euro area. The April 2018 readings were 0.6 headline and 0.2 percent core, versus 1.2 and 0.7 percent in the Euro area.

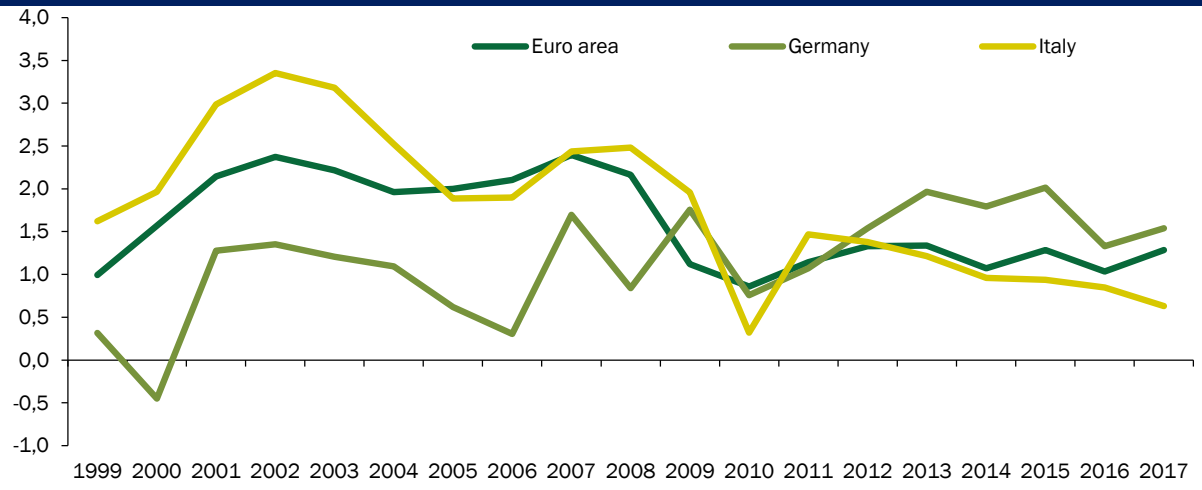
FIGURE II.5 – HARMONISED INDICES OF CONSUMER PRICES (ALL ITEMS, 2015=100), PERCENT CHANGE Y-O-Y



Source: EUROSTAT.

- For the fifth year in a row, Italy's deflator in 2017 grew significantly less than in the Euro area. The gap was 0.7 percentage points vis-à-vis the Euro area average and 0.9 points versus Germany.

FIGURE II.6 – GDP DEFLATOR GROWTH, PERCENT Y-O-Y

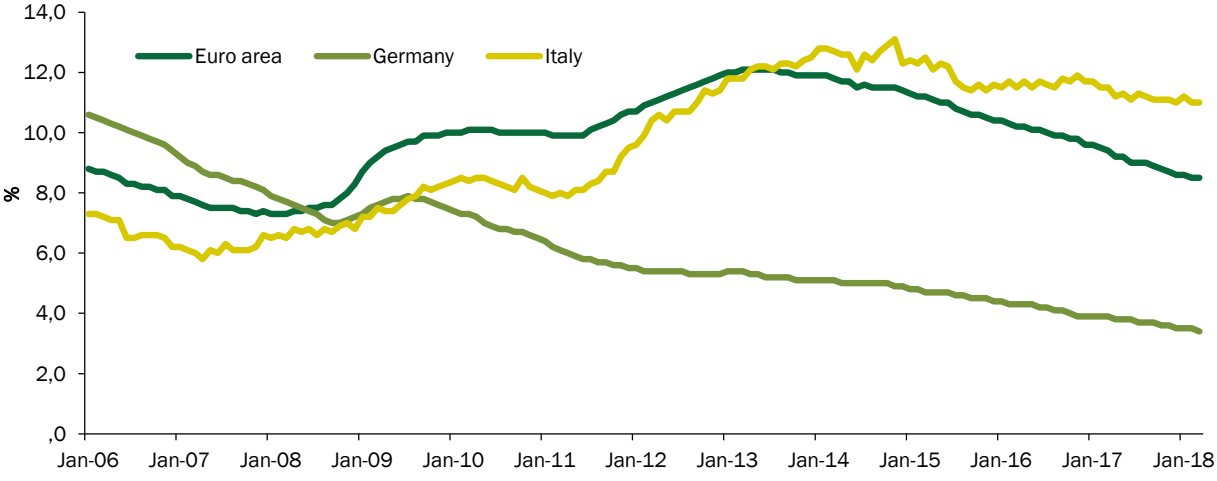


Source: EUROSTAT.

Slack in the economy is the key factor driving Italy's negative inflation differential vis-à-vis the resto of the Euro area. The latest Eurostat data (for March 2018) show an unemployment rate of 11.0 percent in Italy, 8.5 percent in the Euro area and 7.1 percent in the EU28. Germany's unemployment rate has hit a new low of 3.4 percent. It is worth recalling that prior to the 2008 crisis and until 2009, Italy had a lower unemployment rate than Germany.

Although unemployment has declined significantly from its 2014 high, and the number of people in employment has increased by more than a million, the excess supply of labour continues to bear down on wages. However, slow nominal wage growth elsewhere in Europe and in the advanced economies at large means that Italy's recovery in cost competitiveness is inevitably a multi-year process.

FIGURE II.7 – UNEMPLOYMENT RATES (AS A PERCENT OF LABOUR FORCE)



Source: EUROSTAT.

II.2 DEBT RULE IN A DEFLATIONARY ENVIRONMENT

As was argued in previous reports on public debt, low inflation makes it harder to rapidly reduce the debt-to-GDP ratio. The debt-reduction rule that was introduced in 2011 in order to strengthen Euro area fiscal governance is extremely penalizing for high-debt countries in times of low nominal growth. It can be shown that even a member state that has reached a balanced structural budget position may fail to satisfy the debt rule if nominal GDP growth falls below a certain threshold. In Italy's case, given a debt-to-GDP ratio of 131.8 percent (in 2017), the debt rule is more stringent than running a balanced structural budget whenever nominal GDP growth is lower than 2.7 percent.

Ultra-low inflation can be at least partly offset by higher real GDP growth, not only via counter-cyclical policies but also via structural reforms. In recent years Italy has recorded a gradual acceleration in real GDP growth, thanks also to a broad reform effort (see Chapter III). Growth seems to have slowed in the last two quarters, as production trailed domestic final sales. This soft patch is not indicative of a trend reversal, though the risk of a global trade war may have led Italian exporters to revise their production and investment plans.

It is also frequently argued that the government should have responded to slow nominal growth by raising the primary budget surplus. This thesis overlooks the social and political sustainability of harder fiscal austerity. The economic policy followed by the Italian government since 2014 has tried to balance debt reduction and aggregate demand support. Given the gravity and duration of the crisis, it was necessary to moderately raise household disposable income and to introduce poverty-alleviation measures. The consolidation of the economic recovery means that, absent external shocks, budget policy can now aim for gradually higher primary budget surpluses.

III. STRUCTURAL REFORMS

III.1 THE REFORM AGENDA

Italy's ongoing recovery has been aided by a comprehensive structural reform effort. Over the past year, a number of key reforms have been either implemented or completed along the strategic guidelines set by the National Reform Programme, taking into account the 2017 Country Specific Recommendations. The latter have been addressed to Italy also with a view of correcting the excessive macroeconomic imbalances, identified by the Commission in Spring 2017 and related to high public debt and protracted weak productivity growth. In addressing the recommendations, substantial efforts have been devoted to improving tax compliance and combating corruption. Significant progress has also been made on reforming the public administration, eliminating restrictions to competition, restructuring the banking system, increasing the efficiency of civil justice.
The labour market reforms are being complemented by reforms aiming at strengthening the collective bargaining framework and implementing active labour market policies.

MAIN STRUCTURAL REFORMS IN 2017

	Areas	Policy area	Actions
1	Debt and public finance	Public finance	Spending review as part of the budget procedure
2		Public finance	Strengthen the debt reduction strategy through disposal of real estate assets and reform of concessions
3	Taxation, and fight against tax evasion	Fiscal policies	Reduction of the fiscal burden to support growth and annual Report on *tax expenditures* as first step to rationalize tax expenditures.
4		Fiscal policies	Reduce tax disputes and improve the effectiveness of collection, also through a higher efficiency of tax administration (through ICT investments and human resources).
5	Credit	Banks and Loans	Reduction of non-performing loans (NPLs) and reform of governance of banking system
6		Banks and Loans	Reform the rules on corporate crisis and insolvency procedures (Enabling Law)
7		Banks and Loans	Attract foreign investments and monitoring alternative measures to bank credit
8	Labour, welfare and productivity	Labour and welfare	Implementation and monitoring of active labour market policies
9		Labour and welfare	Support for female and youth employment
10		Labour and welfare	Improve labour productivity and enhance competitiveness
11		Labour and welfare	Self-employment reform and reform of ancillary work
12		Labour and welfare	Fight against poverty: introduction of inclusion Income (*Reddito di Inclusione*)
13		Labour and welfare	Measures to support the family
14		Education and VET	Implementation of the '*Buona Scuola*' reform and of National Plan for the Digital Educational System
15		Education and VET	'*Competence Centres*' and other measures to support ICT skills.
16	Investments	Investments	National Plan for public investment and implementation of Agreements for the South
17		Investments	Update the procurement legislation and monitoring of the provisions' effectiveness
18	Competitiveness	Competitiveness	Implementation of the ports system reform and National Plan for Ports and Logistics
19		Competitiveness	'*Impresa* 4.0' Plan
20		Competitiveness	Startup and Innovative SMEs
21		Competitiveness	Strategic Plan for Tourism
22		Competitiveness	The National Energy Strategy 2017 and the Energy Decree
23		Competitiveness	Approval of the Annual Law for Market and Competition
24		PA	Complete the reform of the Public Administration and of public employment
25		PA	Complete the reform of local public services and rationalization of state-owned enterprises
26		PA	Implementation of the Simplification Agenda, updating of the 2018-2020 Agenda, three-year Plan for ICT in the PA
27		Justice system	Reform of the criminal justice and the statute of limitation terms
28		Justice system	Efficiency in civil proceedings

The commitment to a responsible management of the public finances has been pursued with the budget reform approved in August 2016, by integrating the spending review into the annual budget process. According to the Budget reform, each ministry is requested to select areas for targeted savings within its own budget. The new process was implemented for the first time in 2017 with reference to the 2018-2020 planning period. The objective of rationalising expenditure (established by the 2017 Economic and Financial Document) to be realised by the central administrations has been set at 1 billion for each year, starting from 2018, in terms net budgetary savings. An integral part of the systematic spending review is the centralised procurement programme, which – together with the new Code of Public Procurement - will also contribute to further increasing the transparency and efficiency of the process. According to a recent MEF-ISTAT Survey – which recorded the prices for goods and services purchased by the Public Administration - the agreements stipulated by CONSIP brought significant savings. Indeed the prices paid on the basis of these agreements were lower than those for purchases made directly by the Public Administrations.

Measures undertaken to secure the sustainability of public finances also relied on a continuous attention to combating tax evasion and strengthening tax collection. The latter has substantially improved in 2017 (+44 percent of revenue collected compared to 2016) with an overall increase of almost 4 billion. In the same year the measures taken against tax evasion led the recovery of 25.8 billion in revenue, with a considerable increase compared to the previous years (16.4 billion in 2013). To fight tax fraud and reduce the VAT gap the 'split payment' has been extended to all transactions by Public Administrations, companies under direct or indirect control, listed companies, professionals dealing with Public Administrations. Of the same relevance to this aim is the extension of mandatory electronic invoicing to all private sector transactions from 2019. This measure will allow the tax administration to cross-check the various transactions declared by tax payers and to monitor VAT payments. It is estimated that mandatory e-invoicing will generate more than 2 billion a year of additional revenue.

In 2017 the government's efforts have been intensified with the aim of returning the banking system to health, increasing market confidence in the Italian banks and enhancing the overall quality of credit. Reforms implemented in the last year have tackled the main vulnerabilities of the sector, with particular attention to non-performing loans (NPLs), the improvement of corporate governance, low profitability and credit recovery times.

Better economic conditions have positively impacted on the quality of credit, taking the rate of credit deterioration back to pre-crisis levels. In 2017 NPLs disposal gained momentum and the flow of new NPLs[3] in proportion to total loans have stabilised near the levels recorded in the mid-2000s (around 2.0 percent). Banks are increasingly shedding NPLs from their balance sheet. The ratio between the amount of NPL cancellations and the stock at the beginning of the period has increased from 6 percent in 2013 to 9 percent in 2016. In the second half of 2017, 26.5 billion of NPLs were sold (compared to 5.7 billion in the first semester), nearly two thirds of which through securitisations, and in many cases with recourse to the state guarantee scheme. Banks also sold some 2 billion worth of NPLs not classified as bad loans. This allowed them to considerably reduce the stock of NPLs, by 40 billion gross of provisions and by 16 billion net of provisions, and to lower the ratio of NPLs to total loans to 14.5 percent and to 7.5 percent (gross and net of provisions, respectively).

[3] See Bank of Italy, "Financial Stability Report", No. 1/2018, http://www.bancaditalia.it/media/notizia/financial-stability-report-no-1-2018/

Another significant aspect is the decrease in the dispersion of the credit quality indicator, even if NPLs ratios are still high for several banks. In the third quarter of 2017 the Commission progress Report[4] registered an overall reduction in the EU of the ratio between gross NPL and gross loans by 1.1 percentage points on an annual basis (from 5.5 to 4.4 percent). In the same period, the same ratio shrank in Italy by 4.0 percentage points. Nevertheless, the Italian ratio was still at 12.1 percent.

In 2017, systemically relevant Italian banks with high levels of NPLs achieved results in line with the reduction objectives set out in the three-year plans they presented to the supervisory authority. Moreover, in March 2018 the banks submitted their updated 2018-2020 three-year plans calling for an overall reduction of 38 percent in non-performing exposures. By the end of 2018, smaller banks with high NPL levels will also be required to arrange strategies and operational plans consistent with the guidelines issued by the Bank of Italy in January.

In line with the interventions directed to improve the corporate governance and the efficiency of the banking sector, larger cooperative banks were forced to become joint-stock companies and small mutual banks were reformed. Only two cooperative banks, among those affected by the reform, have not yet decided to transform into a joint-stock company (*Banca Popolare di Sondrio* and *Banca Popolare di Bari*).

After the approval by the European Commission and the ECB of the precautionary recapitalisation of *Banca Monte Paschi di Siena* (BMPS), the Ministry of Economy has participated in the capital increase for approximately 3.9 billion and repurchased the shares deriving from burden sharing for retail investors for around 1.5 billion. Once the repurchase of the shares deriving from burden sharing was completed, the Economy and Finance Ministry's participation in the BMPS capital rose to around 68 percent. The bank will dispose of 28.6 billion of gross NPLs, including 26.1 billion through a dedicated securitisation transaction. The *Atlante* II fund will acquire the junior and mezzanine securities. Finally, the legislative gaps in Italy's implementation of the EU fit and proper rules for bank management are being tackled through a ministerial decree to be shortly finalised (after the consultation phase started in August 2017).

Some progress has been made in tackling the weaknesses in the insolvency framework where a comprehensive reform has been initiated by the delegated Law approved in October 2017 empowering the Government to adopt the necessary decrees to reform the 1942 bankruptcy code and the over-indebtedness legislation. The characteristic of the new legislation is to define a regulatory framework in which the legal principles common to the insolvency phenomenon are well defined, albeit with the necessary differentiations dictated by the different situations in which insolvency can occur. The following are among the most relevant novelties introduced by the new discipline:

- the expression 'bankruptcy' is replaced by a 'judicial procedure of assets liquidation' embedding a possible agreed solution and the complete release of debts within a maximum of 3 years from the opening of the procedure;
- to favour the early restructuring of companies, a preventive and extrajudicial phase is introduced aimed at anticipating the emergence of a crisis through a preliminary

[4] See European Commission, "Second progress report on the reduction of non-performing loans (NPLs)", March 2018.

analysis of the underlying causes. This phase can lead to an assisted settlement of the crisis, aiming to reach an agreement with the creditors;

- the insolvency procedures are entrusted to specialised judges;
- in order to facilitate a faster decision-making process, limiting the hindrances of minority creditors, more efficient restructuring agreements are envisaged;
- the possibility of carrying out a unique procedure for dealing with the insolvency of groups of companies is introduced, and if possible a single court is identified;
- measures are introduced facilitating credit access, especially for small businesses, and forms of guarantee are allowed that do not impose the loss of ownership of the asset granted as collateral;
- more effective corporate controls are introduced.

To increase the efficiency in the management of insolvency proceedings some innovative tools have been set up. Among them: a) the public sales portal, where the auction notices for foreclosed real property have to be published and b) the Electronic Register of the forced foreclosed proceedings, insolvency and crisis management procedures (the publication of its functioning rules is ongoing). Both instruments represent a key step in the process of digitalizing judicial procedures.

According to the 2017 CSRs, Public Administration inefficiencies, the length of legal proceedings and weak competition still hamper productivity growth. To this aim, several reforms have been started in recent years and some of them have been completed in 2017. It is the case of the Public Administration reform, whose implementing decrees have all been issued, including the one aimed at reforming and rationalising State Owned Enterprises. Among the measures directed at improving the functioning of the public administration the administrative simplifications have registered some progress. The sixth report on the implementation of the Simplification Agenda[5] - released at November 2017 - showed that 96 percent of deadlines had been met. The update of the Agenda for 2018-2020 is underway.

The reform of justice system aimed at improving the efficiency of both civil and criminal trials. With the definitive approval of the Enabling Act reforming the criminal process, the government is empowered to introduce substantive and process-related changes with the objective of simplifying and accelerating the execution of criminal proceedings, also reducing pending cases, thereby implementing the principle of reasonable duration of the criminal proceedings. The new provisions aim to update the procedural safeguards for the accused, and to take into consideration the guidelines set at a European level. The novelties introduced in the criminal process also include the reform of the statute of limitations: the new rules provide for the suspension of the statute of limitations for 18 months both after a conviction in the lower court, and after a conviction in any appeal.

The efficiency of civil justice has benefitted from a reduction in the length of proceedings as a result of greater specialisation of courts and the digitalisation of trials. In 2017 the case backlog in the civil court continued its positive trend of reduction (-4.5 percent with respect 2016). The number of cases pending for more than three years in the lower courts (with the risk of application of the *'Pinto'* Law) also diminished, while the

[5] http://www.italiasemplice.gov.it/media/2524/vi-report-di-attuazione-dellagenda-per-la-semplificazione-30112017.pdf

payments have been accelerated thus reducing the debt towards citizens. In 2017, the number of pending criminal cases decreased by 0.5 percent with respect 2016. As regard the alternative dispute resolution methods (ADR) data show a strong use of these new instruments that contributed not only to the reduction of the backlog but also of the new cases registration (from 4 million in 2013 to 3.2 million at the end of 2017). This trend has allowed Italy to climb 52 positions in the 'Enforcing contracts' indicator of the World Bank's Doing Business report. In the 'Quality of judicial index' indicator Italy ranked 13th (out of 18), better than other countries such as Germany, Spain, Switzerland and above the OECD average. The digitalisation of proceedings and the ADR measures positively contributed to these results.

Among the reforms recently enacted, the 2015 Annual Competition Law was approved by Italian Parliament in August of last year. The competition law intervenes in a number of sectors: insurance; communications and postal services; energy and environment; banks; professions and pharmacies; tourism, culture and transportation services. The key principles that inspired the law are: a) removing the entry/exit barriers to markets by allowing the adoption of innovative organisational models; b) promoting the mobility of demand through a greater transparency; c) improving consumer protection. The full operationalisation of the Law depends on the issuance of further legislative and regulatory measures, in particular in the insurance, telecommunication and banking sectors, professions and cultural heritage. In the energy sector, the expected regulatory act to facilitate the comparison of the offers in the energy retail market has been identified by the sectoral Authority. The law also foresees an enabling law to liberalise the taxi sector to be issued by September 2018. In the transportation sector various legislative measures have complemented the Competition law by dictating new rules; it is the case of the local public transport, where general principles regarding the organisation of the service, regulation and competition have been introduced[6], affirming the separation of the regulation, planning, organisation and control functions from those of operating local and regional transportation. Other provisions address the granting of local and regional public transport licences, and introduce financial penalties for regions that award contracts directly, without a public tender.

The “Industry 4.0” Plan was launched at the end of 2016, providing a range of incentives to boost innovation and skills and modernise the productive system of the country through a technological upgrade. The implementation of the Plan shows encouraging results: in 2017 orders from the domestic market have increased with a peak of 13 percent for machinery and other equipment. Also data on companies that in 2017 benefited from the tax credit for R&D and innovation expenditures are positive (+104 percent compared to 2016). In 2017 the Plan (later re-named *Impresa 4.0*) has been targeted to innovative investments through the reinforcement of the super-amortisation and hyper-amortisation schemes. They give companies the possibility of deducting respectively 140 percent of the amount spent on investments and 250 percent of the expenses in investment in ICTs. Tax credits in 2018 for incremental expenditures on training activities in subjects expressly linked to *Impresa 4.0* have also been introduced.

Measures included in the *Impresa 4.0* Plan, the labour market reform (Jobs Act) and the education reform (the *Buona Scuola* reform) acted in a mutually reinforcing way with a view of enhancing the supply of skills relating to new technologies and developing new capacities

[6] Legislative Decree No. 50/2017.

already in the schooling. The overall objective is to continuously increase the employment rate in the country.

As for the labour market, the most relevant measures in 2017 were related to the Jobs Act for self-employed and VET programmes. New guarantees (i.e. the introduction of guarantees against unfair clauses in business operations and payment delays and the extension of maternity protection and social protection) were introduced for the self-employed. To develop VET programmes and upgrade ICT skills in the context of the *Impresa 4.0* Plan, competence centres were established through public-private partnerships. In this framework, the *Buona Scuola* reform introduced a dual system, to reduce the incidence of skill-mismatch between skills possessed by workers and those demanded by employers. The latest data released by the ALMP agency show that VET programmes have become more effective. In particular, the probability of finding a job after 6 months increased from 13 percent in 2012 to 39 percent in 2017.

IV. OUTPUT GAP AND STRUCTURAL BALANCE: ALTERNATIVE ESTIMATES AND COMPLIANCE WITH THE RULES

IV.1 ALTERNATIVE OUTPUT GAP AND POTENTIAL OUTPUT ESTIMATES

As already extensively argued in the in the January 2017 Report on the Relevant Factor influencing the Italian Public Debt[7], compliance with the requirements of the Stability and Growth Pact crucially hinges on the estimation of output gap and potential output.

The EU commonly agreed methodology to estimate potential output and output gap is based on a Cobb-Douglas production function. Such an approach, however, presents several drawbacks that may lead to implausible output gap estimates. Indeed, in the aftermath of the most acute phase of the recession and exceptionally bad cyclical conditions of 2009 and 2012, Italian output gaps estimates, due to the protracted fall in potential output, have been closing very quickly reaching positive territory at the end of the Commission forecast horizon, in spite of a still-high degree of slack in the economy.

Following numerous requests for clarification that were addressed to the Commission's services by several national ministries, in September 2017 the Economic a Policy Committee (EPC) of the European Council gave mandate to the Output Gap Working Group (OGWG) to study the possibility of inserting country-specific elements in the commonly agreed methodology.

On its part, the Italian government raised several country-specific arguments related to the estimation of the Non Accelerating Wage Rate of Unemployment (NAWRU) and the trend/cycle decomposition of Total Factor Productivity (TFP).

According to the government, in the case of Italy, the commonly agreed production function performs poorly with respect to the estimation of the NAWRU, with procyclical estimates at the end of the forecast horizon which are not optimal from a statistical point of view. As far as TFP is concerned, its measurement for Italy is subject to some relevant shortcomings given that the current estimates of the TFP trend have recorded negative growth rates since 2003.

To address both issues, the Italian Treasury proposed some country-specific enhancements which, however, maintained the original structure of the EU commonly agreed production function and introduced only marginal, although crucial, variations to the method. More details on the Italian proposals are available in an ad hoc focus presented in the 2018 the Stability Programme[8].

With reference to the NAWRU, the country specific proposal envisages the use an iterative procedure, the so-called Grid Search developed in house by the Italian Treasury

[7] See the 2017 Report on the Relevant Factors influencing debt developments in Italy, also available at: http://www.mef.gov.it/inevidenza/documenti/Italy_Relevant_Factors_February_2017.pdf

[8] See the Focus on "La Stima del prodotto potenziale e dell'output gap: una metodologia alternativa a quella concordata a livello europeo" in chapter III of the 2018 Economic and Financial Document, Stability Programme, also available at: http://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2018/DEF_2018_-_Sez.1_-_Programma_di_Stabilitx.pdf

which, on the basis of a set of statistical criteria, allows to select the initial variance bounds parameters of the model in a less discretionary fashion than currently foreseen. Thanks to the Grid Search procedure, the NAWRU estimates for Italy are sounder from a statistical point of view and less procyclical than those produced by the European Commission. Given such a features, the EPC and the European Commission agreed on using the Grid Search, initially for Italy and in a second moment for all EU Member States.

As far as the Total Factor Productivity is concerned, Italy put forward two additional proposals. The first one concerns the index of capacity utilisation (CUBS) currently adopted for the trend-cycle decomposition of Total Productivity of Factors. This indicator currently consists of three different components: the capacity utilization index of the manufacturing sector, the sentiment indicator of both the construction and of the service sectors.

The latter, in the Italian case, presents several shortcomings, including the substantial unreliability of the data before 2003 (due to modest sectoral coverage of the sample) and a trend generally not correlated with the underlying real activity indicators. For these reasons, Italy originally asked to replace, for the calculation of the CUBS, the services sentiment indicator with the corresponding capacity utilization index which, however, is available only from 2010.

The European Commission has been originally in favor of introducing the capacity utilization index for services, but requested to rebuild retrospectively the series for the years prior to 2010 using the information from the service sentiment indicator so as not to lose the representativeness of the CUBS indicator.

This retrospective reconstruction, however, would have produced counter-intuitive results, with values of the capacity utilization of services for 2007 (proxying the last cyclical expansion) lower than those of 2017. Since no compromise solution has been reached for the backward reconstruction of the capacity index used in services, Italy has further modified the initial proposal requesting to continue using the sentiment indicator for services but dropping the records from 1998 to 2002 and considering the series only from 2003 onwards.

Such proposal has been accepted by the OGWG and ratified by the Economic Policy Committee and therefore has been used by the European Commission for the 2018 Spring Forecast.

The second proposal put forward by Italy for the estimation of the TFP trend and cycle components envisages the possibility of adding a measure of labor hoarding to the CUBS composite index. Labor hoarding indicator has been derived on the basis of the hours of ordinary and extraordinary Cassa Integrazione Guadagni (CIG) requested by companies, removing the components related to bankruptcy purposes which are not directly connected to the economic cycle.

In spite of the strong theoretical backdrop, this proposal did not obtained the consent of the European Commission and of the other Member States at the OGWG, as the labor hoarding index was considered too subject to policy and discretionary changes that could alter its cyclical properties.

A further issue, not yet brought to the attention of the OGWG but on which the Commission promised to intervene, emerged after the publication of the 2017 Autumn Forecast of last November. It concerns, the estimate of the so-called structural unemployment rate, i.e. the value of medium-term anchor to which the NAWRU is projected

to converge over the medium term, which is also essential to obtain the estimates of the NAWRU over the short time horizon.

Currently the anchor is calculated with a panel model that regresses the NAWRU values obtained with the Kalman Filter model for the EU-15 old member states on some labour market variables considered' structural (such as the rate of replacement of unemployment benefits, the tax wedge, the union density, a variable that measures the level of active labor market policies) and macroeconomic' non-structural 'variables (such as the growth of TFP, the real interest rate, a variable controlling the cyclical performance of the construction sector).

In the case of Italy, the value of the structural unemployment rate anchor rose by 1 percentage point from the 9 percent estimated in the 2017 Spring Commission Forecasts to 10 percent of the November Autumn Forecast.

The causes of this increase are attributable to the dynamics of the variable that measures the rate of replacement of unemployment benefits. In spite of the recent reform of the Jobs act that enhanced unemployment subsidies scheme in Italy, the series used for measuring the replacement rates of such benefits presents for Italy an irregular pattern that does not adequately reflect the reality of the data. In particular, the sudden growth recorded from 2015 in the update of the dataset made in the autumn of 2017 seems not plausible and produces a substantial worsening on the value of the anchor.

Given the irregularity of the data in some specific points of the series, a correction to be included in the calculation of the value of the anchor has been put forward in the 2018 Economic and Financial Document[9] (DEF 2018) which consists in multiplying the coefficient resulting from the panel estimate not for the value of the replacement rate of subsidies unemployment related to the last year (European procedure), but for an average calculated on the whole sample.

This procedure is similar to the one already used for the variables considered 'non-structural' and since it intervenes ex post with respect to the estimate of the panel model, the proposed variation would not involve any change for the other Member States. For Italy, however, the value of the anchor in the official Commission estimates would decrease from 10 percent to 8.3 percent.

While the country-specific changes to the commonly agreed methodology that were accepted by the Commission and endorsed by the OGWG and EPC (i.e. the grid search for NAWRU bounds and a shorter sample on the sentiment indicator for services in the CUBS index) represent a step in the right direction in making output gap and potential output more plausible from a macroeconomic point of view, the Italian government believes that such improvements are minimal and do not solve the issues related the lack of economic intuition behind the protracted negative TFP trend growth for Italy and those concerning the lack of explanatory power of the current version of the Phillips curve.

By contrast, the full proposal put forward by Italy, which includes, in addition to the approved methodological enhancements, also the labour hoarding index based on CIG hours for the TFP trend/cycle decomposition and a more plausible medium term structural unemployment anchor, if applied jointly, would lead to significant changes in the estimates

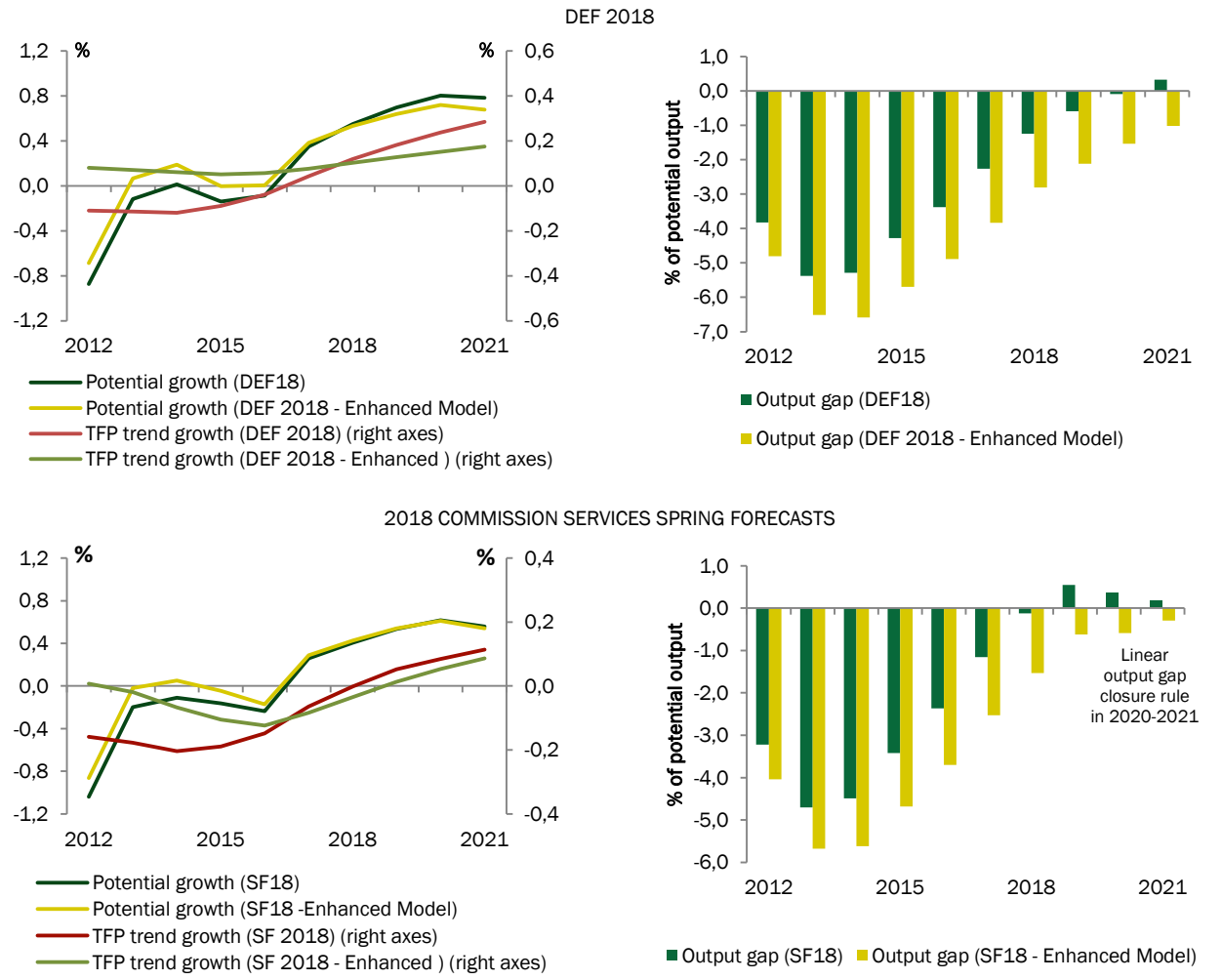
[9] The Economic and Financial Program comprises the Stability Program, the National Reform Program and several other reports, such as an in-depth analysis of the public finances and a report on Sustainabile and Inclusive Development.

of potential output, allowing to deal, at least partly, with the issue of the protracted negative TFP trend growth.

In figure IV.1 the alternative methodology has been applied to both the trend macroeconomic scenario of the DEF 2018 as well as to the 2018 Commission Services Spring Forecast, producing estimates that are significantly different from those obtained using the methodology agreed at European level. In particular, both the growth rate of trend of TFP as well as the potential output growth, as estimated in the enhanced methodology, are less procyclical than in the current agreed production function approach, thus reaching comparatively higher rates during the crisis and less sustained values during the current upturn.

As a result, under the enhanced framework, in both the DEF and Spring Forecasts specifications, the level of potential product is higher over the historical sample as well as during the forecast years 2018-2021 resulting in wider output gap that remains always in negative territory until the end of the projection horizon.

FIGURE IV.1 – ALTERNATIVE POTENTIAL GROWTH AND OUTPUT GAP ESTIMATES



Source: MEF simulations on DEF 2018 and on Commission Services Spring Forecasts 2016.

Accordingly, the structural balance under the alternative specifications would look quite different from what officially estimated using the commonly agreed production function methodology. For instance, using the enhanced method, respectively for the DEF and for the 2018 Spring Forecasts scenarios, the structural balance would record in 2015 a significant surplus in the first case and a slight one in the second. The Italian public finance would have then attained the Medium Term Objective (MTO) with relevant consequences regarding compliance with the preventive arm of the Stability and Growth Pact (Table IV.1).

TABLE IV.1 – OUTPUT GAP AND STRUCTURAL BALANCE UNDER DIFFERENT METHODOLOGICAL ASSUMPTIONS FOR THE ESTIMATION OF POTENTIAL OUTPUT

		2015	2016	2017	2018	2019
DEF 2018	Output gap	-4.3	-3.3	-2.2	-1.3	-0.6
	Structural balance	-0.1	-0.9	-1.1	-1.0	-0.4
DEF 2018 - Enhanced methodology	Output gap	-5.7	-4.9	-3.8	-2.8	-2.1
	Structural balance	0.7	0.0	-0.2	-0.2	0.4
Commission SF 2018	Output gap	-3.4	-2.4	-1.2	-0.1	0.5
	Structural balance	-0.6	-1.4	-1.7	-1.7	-2.0
Commission SF 2018 - Enhanced methodology	Output gap	-4.7	-3.7	-2.5	-1.5	-0.9
	Structural balance	0.1	-0.7	-0.9	-0.9	-1.2

Source: MEF elaborations on 2018 DEF 2017 and on Commission Services Spring Forecasts 2018.

IV.2 STRUCTURAL DEFICIT, FISCAL CONSOLIDATION AND CONVERGENCE TO THE MTO

Under the preventive arm of the SGP, compliance with the required fiscal effort may be highly dependent on the way cyclical conditions are assessed through output gaps and potential output calculations.

Bearing on the alternative output gap and potential growth estimates that could be retrieved adopting the enhanced production function methodology proposed by the Italian authorities, compliance with the preventive arm of the Stability and Growth Pact has then been re-assessed both for the DEF 2018 trend scenario as well as for the 2018 Commission Services Spring Forecasts (Table IV.2).

On the basis of the official output gap figures for 2016, produced through the commonly agreed production function methodology, Italy would qualify as being in “very bad times” according to the estimates of the DEF 2018 and in “bad times” on the basis of the results of the Commission spring forecasts.

According to the matrix that specifies the fiscal adjustments in the preventive arm of the SGP, Italy would then be required to converge towards the MTO reducing the structural deficit by 0.25 percentage point on the basis of the official estimates of the EFD and by at least 0.5 percentage points on the basis of the Commission services Spring Forecasts.

However, in 2016, the Italian government requested the full application of the budget flexibility allowed under the preventive arm of the SGP. Taking into account the flexibility foreseen by the Structural Reforms clause and the one for EU co-financed investments together with the flexibility granted for unusual events (refugees and public security), the required fiscal effort would translate into a deficit increasing change of 0.58 percentage points of GDP in the structural balance in the case of the DEF and of 0.33 percentage points in the case of the 2018 Spring forecasts.

TABLE IV.2 – COMPLIANCE WITH THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT UNDER DIFFERENT OUTPUT GAP SPECIFICATIONS

Convergence to the MTO	DEF 2018		DEF 2018 Enhanced methodology for the estimations of Output Gaps		2018 Spring forecasts		2018 Spring forecasts, Enhanced methodology for the estimations of Output Gaps	
	2016	2017	2016	2017	2016	2017	2016	2017
Output gap	-3.4	-2.3	-4.9	-3.8	-2.4	-1.2	-3.7	-2.5
General Government deficit (%of GDP)	-2.5	-2.3	-2.5	-2.3	-2.5	-2.3	-2.5	-2.3
Medium Term Objective (MTO)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Structural deficit(% of GDP)	-0.9	-1.1	0.0	-0.2	-1.4	-1.7	-0.7	-0.9
A=change in the structural deficit	-0.7	-0.2	-0.7	-0.2	-0.7	-0.3	-0.7	-0.2
B=required change in the structural deficit	-0.58	0.15	-0.83	-0.11	-0.33	0.25	-0.58	0.15
C=A-B (no more than-0.5pp) Annual deviation from the required change in the structural balance	-0.17	-0.38	0.08	-0.08	-0.42	-0.51	-0.42	-0.39
D=Two-year average change in the structural balance	-0.3	-0.5	-0.3	-0.5	-0.3	-0.5	-0.3	-0.5
E=Required Two-year average change in the structural balance	-0.27	-0.22	-0.78	-0.47	-0.06	-0.04	-0.38	-0.22
F= D-E (no more than -0.25pp) Deviation of the two-year average change in the structural balance from the required values	-0.12	-0.27	0.01	0.00	-0.24	-0.47	-0.24	-0.40

Expenditure Rule	DEF 2018		DEF 2018 Enhanced methodology for the estimations of Output Gaps		Spring forecasts 2018		2018 Spring forecasts, Enhanced methodology for the estimations of Output Gaps	
	2016	2017	2016	2017	2016	2017	2016	2017
A= Annual growth rate in the reference expenditure aggregate(%, in nominal terms)	2.3	1.2	2.3	1.2	1.4	1.2	1.4	1.2
B= Applicable expenditure benchmark rate (nominal) (%)	2.5	0.6	3.1	1.2	2.0	0.4	2.5	0.9
C= (no more than-0.5pp) Annual deviation of the expenditure aggregate from the reference determined by the benchmark(% of GDP)	0.12	-0.24	0.37	0.01	0.28	-0.35	0.52	-0.13
D= (no more than -0.25 pp) Two-year deviation of the expenditure aggregate from the reference determined by the benchmark (% of GDP)	0.28	-0.06	0.40	0.19	0.35	-0.04	0.48	0.19

Source: MEF simulations on DEF 2018 and on Commission Services Spring Forecasts 2016.

Vis-à-vis the possibility to increase the deficit, the deterioration of the structural deficit of 0.7 percentage points of GDP recorded in 2016 according to the Spring Forecasts and the DEF would not be significant. In addition, the expenditure aggregate is expected to grow, in nominal terms, by 2.3 percent and in line with the respective benchmark. On the basis of such results, no significant deviation on the path of convergence to the MTO would have been recorded in 2016.

For 2017, on the basis of output gap estimates produced through the commonly agreed production function methodology, Italy would qualify as being in "bad times" according to the estimates of the DEF and in "normal times" on the basis of the results of the Commission spring forecasts. According to the matrix that specifies the fiscal adjustments in the preventive arm of the SGP, Italy would then be required to converge towards the MTO reducing the structural deficit by 0.5 percentage point on the basis of the estimates of the DEF and by at least 0.6 percentage points on the basis of the Commission services Spring Forecasts.

However, in 2017, the Italian government has been granted additional budget flexibility for unusual events amounting to 0.35 per cent of GDP to face the costs of the refugees as well as the costs of the earthquakes that hit the central regions of the country. Against such backdrop, the required fiscal effort to be compliant with the preventive arm of the Stability and Growth Pact would translate into an adjustment of 0.15 percentage points in the case of the DEF and of 0.25 percentage points of GDP according to the 2018 Spring Forecasts.

Vis-à-vis such requirements, the structural deficit is estimated to worsen of 0.2 percentage points of GDP in the Italian Stability Programme resulting, respectively, in a yearly not significant deviation of 0.38 percentage points of GDP and in an average gap of 0.27 percentage points of GDP calculated over the year 2016-2017 which is only marginally out of track. By contrast, the expenditure aggregate is expected to grow, in nominal terms, by 1.2 percent only slightly deviating from the required benchmark.

On the basis of the 2018 Spring forecasts, the Italian structural deficit for 2017 is estimated to worsen by 0.3 percentage points of GDP producing a slightly significant deviation of 0.51 percentage points of GDP on an annual basis and of 0.47 percentage points over the two year average. Instead, the expenditure aggregate growing in nominal terms of 1.2 percent would not significantly deviate from the required benchmark, thus signaling the overall compliance of the Italian public finance framework with the requirements of the Stability and Growth Pact.

As already anticipated, compliance with the requirements of the preventive arm of the SGP has been reassessed by re-calculating output gaps and potential output estimates of both the DEF 2018 and the 2018 Commission services Spring Forecasts through the use of the enhanced production function model described in the previous section. The ten-year potential growth average which is functional to the derivation of the expenditure rule has been recalculated for the 2018 Spring Forecasts using the same enhanced methodology.

On the basis of such alternative methodology applied to the DEF 2018 outlook, the Italian economy would indeed experience exceptional bad times in 2015 and 2016 (with output gaps being wider than -4.0 percent of potential output). The huge slack in the economy measured by the enhanced methodology would have allowed Italy to comfortably reach a surplus on the structural balance, and hence the MTO, already in 2015.

With respect to such a situation, the worsening of the structural deficit of 0.7 percentage points recorded in 2016 would not represent a deviation from the MTO which will be, overall, maintained also in 2017 with a structural deficit lower than 0.2 percent of GDP. Relying on such alternative output gap estimates, the Italian public finances would be more than in line with the requirements of the Stability and Growth Pact. No deviations would be recorded neither in 2016 nor in 2017.

When the enhanced potential output and output gap methodology is applied to the 2018 Commission services Spring Forecasts, the assessment of compliance with the requirements of the preventive arm of the Stability and Growth Pact is more benign than on the basis of official figures, as far as 2017 is concerned. Indeed, under the enhanced specification, the output gap for 2017 would be -2.5 per cent of potential output, signaling still-negative cyclical conditions. The required fiscal adjustment according to the matrix would then be 0.5 percentage points of GDP and not 0.6 percentage points as expected under the official Commission results. With respect to such milder target, the deviation of the structural deficit would not be significant, being equal to 0.39 percentage points of GDP, whereas a significant deviation would be recorded on the basis of the two-year average. By contrast, using the alternative methodology the expenditure aggregate would be in line with requirements with no substantial deviations.

IV.3 CYCLICAL CONDITIONS AND THE DEBT RULE

Compliance with the debt reduction benchmarks has become increasingly demanding for Italy and, in general, for high debt countries.

Figure IV.2 shows the gaps with the debt reduction benchmarks in all debt rule configurations for 2017 both under the current legislation scenario of the Italian Stability Programme (DEF 2018) and under the no-policy change assumption featuring the Commission services Spring Forecasts.

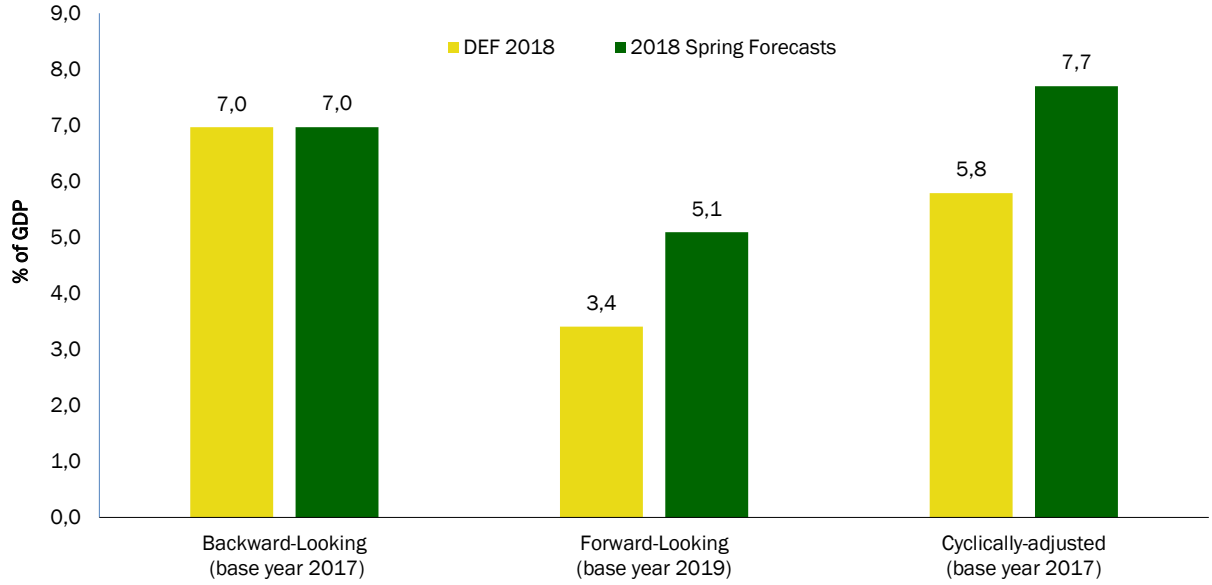
In spite of the very bad cyclical conditions experienced by Italy in the aftermath of the sovereign crisis of 2012 and in a context of protracted low-flation and concrete risks of deflation, the gap to the cyclically-adjusted debt benchmark is estimated to be substantial in 2017.

According to the 2018 Commission services Spring forecasts, the adjustment of the debt-to-GDP ratio to take into account the impact of large negative cyclical conditions recorded by Italy in 2015, 2016 and 2017 would be even more penalizing as the gap produced by cyclical adjusted debt index would be even larger than the one recorded on the basis of the backward looking configuration[10].

Such counterintuitive result is explained by the fact that the Commission, on the basis of implausible negative TFP trend growth estimates posts large negative and procyclical potential output growth rates for Italy.

[10] In this respect, the formula used to cyclically adjust the debt-to-GDP ratio in the framework of the SGP debt rule subtracts, in the numerator, the cyclical component of the budget balance of the current and previous two years, from the current year debt level. Similarly, the level of GDP in the denominator is re-calculated by using potential GDP growth and, in order to account for inflation, the growth rate of GDP deflator of the current and previous two years. The resulting cyclically-adjusted debt-to-GDP ratio is then compared with the debt reduction benchmark obtained through the backward looking configuration. In case the debt-to-GDP ratio cyclically-adjusted is lower than the benchmark, the debt rule is complied with.

FIGURE IV.2 – GAPS TO THE DEBT-REDUCTION BENCHMARKS: RESULTS FROM THE DEF 2018 VS 2018 SPRING FORECASTS



Source: MEF elaborations on 2018 DEF 2017 and on Commission Services Spring Forecasts 2018.

Weaker and even negative growth impacts the evolution of the debt-to-GDP ratio through the cyclical deterioration in the budget balance and the lower nominal GDP levels. However, when potential growth is estimated to be lower than the actual figures or even negative, the debt rule in the current cyclically-adjusted configuration, may completely fail to take into account the exceptionally weak economic circumstances such as the persistent negative cyclical conditions, and ultra-low inflation, because the deadweight burden stemming from negative or very low potential growth would easily offset the gains that would be obtained by correcting the stock of debt for the impact of the cycle.

On top of such conclusions, the European Commission in its reply to a Report of the Court of Auditors has further highlighted the importance of adequately taking into account deflation and the inability of the current debt rule mechanism to incorporate inflation dynamics. In this regard, the Commission has concluded that the cyclically adjusted debt-reduction benchmark does not fully capture the impact of very low inflation over extended periods[11].

According to the European Commission, while the cyclically-adjusted debt level is developed with the aim of excluding the influence of the economic cycle on the assessment on compliance with the debt rule, the adjustment only corrects for the difference in the potential and the actual GDP growth rate over three years. Therefore, the protracted subdued nominal GDP growth experienced by several Member States in the last couple of years could still impact on compliance with the debt rule, even when assessed on the basis of the cyclically adjusted debt level.

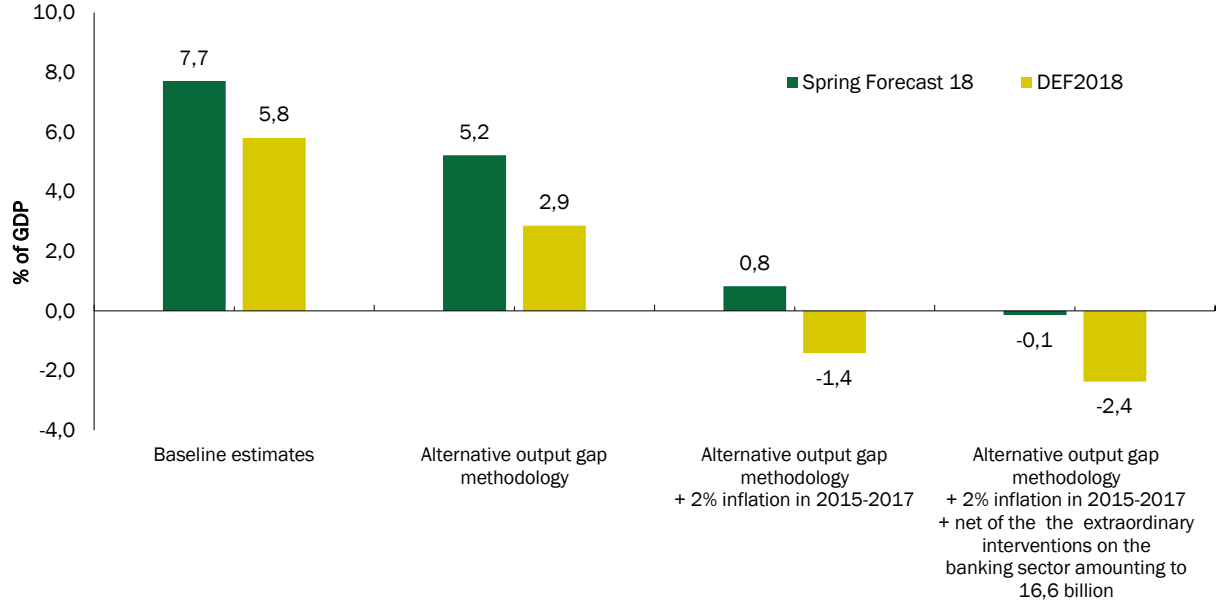
[11] See, European Court of Auditors, Special Report No 10/2016, 'Further improvements needed to ensure effective implementation of the excessive deficit procedure' (also available at: https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=36011) which contains the European Commission Reply to the issues raised by the Court.

In addition, the Commission has confirmed that the debt benchmark does not control for the evolution of prices. The cyclically adjusted debt level uses the observed GDP deflator, thus there is no correction for unexpectedly low inflation. However, for several countries the unexpected lowering of inflation has led to a significant increase public debt financing costs in real terms. As a result, debt dynamics was adversely affected by a widening gap between the real financing cost and the real GDP growth rate.

In this vein, the ECB[12] has underlined that negative inflation/growth surprises tend to make compliance with the requirements of the debt rule more demanding in the short term. In order to assess compliance of Italy's public finances with the fiscal adjustment required during the transitional regime of the debt rule, the ECB has carried out several simulations in which both the impact of low inflation and negative growth rates were taken into account. In particular, the simulations assumed higher GDP deflator growth as for 2014 (2 percent) and real GDP growth of zero in 2014 (instead of the real GDP contraction). Under these assumptions, the fiscal adjustment required to comply with the debt rule would have almost halved for Italy over the period 2013-2015. The structural adjustment achieved in 2013 would have been in line with the requirements adjusted for low inflation and growth, while for 2014 and 2015 the actual adjustment would have fallen short of the requirements.

In light of these considerations, Figure IV.3 shows how the cyclically-adjusted gap to the benchmark derived for 2017 on the basis of the DEF 2018 and on the basis of the 2018 Commission services' Spring Forecasts would change if the enhanced production function methodology developed by the Italian Treasury was used to estimate potential growth and output gaps.

FIGURE IV.3 – GAPS TO THE DEBT-REDUCTION BENCHMARKS IN THE CYCLICALLY-ADJUSTED CONFIGURATION AND WITH THE ENHANCED PRODUCTION FUNCTION METHOD



Source: MEF simulations on DEF 2018 and on 2018 Commission Services Spring Forecasts.

[12] ECB Economic Bulletin, Issue 3 / 2016, see the special chapter "Government debt reduction strategies in the euro area".

With more appropriate assumptions on the slack of the economy recorded in 2015-2017 such as those provided by the alternative enhanced methodology, the gap to the benchmark would change significantly and compliance with the debt rule would be eased. In particular, the gap with the debt reduction benchmark in cyclically-adjusted terms would be reduced by almost one third under the 2018 Commission services Spring Forecasts and almost halved under the 2018 EFD scenario.

Furthermore, if we assume that the GDP deflator grew by 2 percent[13] per year over the period 2015-2017, in line with ECB simulations, Italy would comply with the debt rule on the basis of the cyclically adjusted specification, as the gap to the debt reduction benchmark, in the DEF 2018 scenario, would be negative and equal to -1.42 percent of GDP.

Finally, by netting out from the stock of debt of 2017 the amount of the extraordinary interventions on the banking sector, quantifiable overall in 16.6 billion euro (about one percentage point of GDP), compliance with the cyclically adjusted debt reduction benchmark would be assured also on the basis of the 2018 Commission services Spring Forecasts scenario.

[13] The assumption on GDP deflator is in line with the historical dynamic for Italy. In fact, the deflator averaged almost 1.9 per cent over the period 2000-2015.

V. DEBT SUSTAINABILITY REVISITED

The Commission 2017 Debt Sustainability Monitor[14], relying on a multi-dimension sustainability assessment, classifies Italy's public finances at high risk in overall terms. This sharp assessment is based, mostly, on the joint consideration of deterministic debt-to-GDP ratio projection scenarios and on three sustainability indicators, S0, S1 and S2, which identify risks over different time horizons[15]. Indeed, while the S1 and S2 indicators measure medium-term and long-term sustainability risks, respectively, the S0 indicator is a gauge of sustainability challenges in the short term (up to 1 year).

Specifically, according to the Commission assessment, Italy's public finance sustainability would be at high risk in the medium term while it would be at low risk in the short term on the basis of the S0 index and in the long run according to the S2 indicator.

On these grounds and on the basis of additional technical arguments, the government believes that Italy's public finances are sustainable and that this should be considered as a mitigating factor in the assessment of compliance with the Stability and Growth Pact debt-reduction benchmark.

The technical arguments that underpin such a conclusion are the following: 1) in the medium term debt-to-GDP projections, the Commission no-policy-change assumption excludes the so-called safeguard clauses, i.e. the VAT increases that were legislated in the 2018 Budget and that, in the absence of offsetting measures, will enter into force in January 2019; 2) the technical definition of the S1 indicator, as revised by the Commission is penalizing for a high-debt country like Italy even in the case of sustainable public finances; 3) age-related expenditures are under control.

V.1 MEDIUM TERM DEBT-TO-GDP PROJECTIONS

The most widely accepted definition of fiscal sustainability assumes that a country is solvent when, under a no-policy-change assumption, the debt-to-GDP ratio is not growing or is decreasing. The level at which debt stabilizes in the medium term matters mostly in view of the probability to lose market access which, however, is difficult to assess on an *a priori* basis.

Contrary to such definition, in the 2017 Debt Sustainability Monitor, the Commission judgmentally considers at high risk Member States whose debt-to-GDP ratios are projected

[14] European Commission, 2017, Debt Sustainability Monitor, Institutional Paper 071.

[15] S0 is a composite index for the risk of fiscal stress in the year ahead the last historical value (the estimates refer to 2017). S0 is calculated on the basis of two thematic sub-indexes incorporating, respectively, only fiscal and financial-competitiveness variables. The medium-term sustainability indicator (S1) shows the required increase in the structural primary balance to be achieved, taking into account the burden stemming from age-related costs, cumulatively from 2020 to 2024 so as to ensure, if such an effort is maintained constant, the convergence of the debt-to-GDP ratio to the 60 percent threshold by 2032. The long-term sustainability indicator (S2) shows the fiscal adjustment in terms of structural primary balance which, if realized within the end of the short term forecast horizon, allows for complying the intertemporal budget constraint over an infinite time horizon.

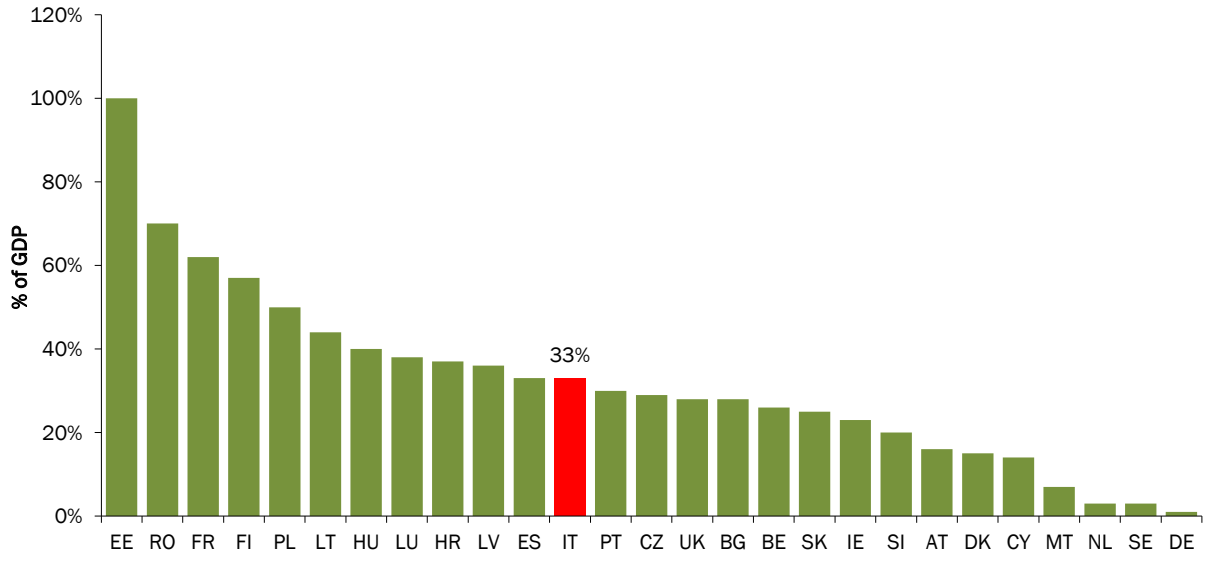
to stay, over the next 10 years, above a threshold, discretionarily chosen at 90 percent. Such a conclusion is questionable, as empirical literature does not support such debt threshold, nor does it point to a specific debt level as the trigger for a sovereign issuer to lose market access.

The stochastic debt simulation analysis carried out by the Commission (to assess the sensitivity of debt-to-GDP projections to shocks simultaneously affecting GDP growth, the yield curve and the primary budget balance) provides a quantification of the probability that the debt-to-GDP ratio in 2022 will be higher than in 2017. For Italy, such probability is 33 percent - lower than in many other EU Member States (Figure V.1).

Against this framework, the developments of Italian public debt over the medium term have been assessed taking into account of both the European Commission 2018 Spring Forecasts and the medium-term projections recently published by the Italian government in the 2018 Stability Programme (DEF 2018).

In the Commission's baseline scenario[16], starting from the no policy change assumption of the 2018 Spring forecasts, it is assumed that, for the period 2020-2027, real output growth evolves in line with country-specific paths derived on the basis of the T+10 production function extrapolation methodology agreed by the Output Gap Working Group (OGWG). On the basis of such assumptions, real GDP growth is projected to be on average equal to a meagre 0.4 per cent over the period 2020-2027.

FIGURE V.1: PROBABILITY THAT THE DEBT-TO-GDP RATIO IN 2022 IS HIGHER THAN 2017



Source: European Commission, 2017 Debt Sustainability Monitor.

[16] The DSM deterministic debt-to-GDP projections are based on the Commission services 2018 Spring Forecasts up to 2019. From 2020 up to 2027, the no-policy change scenario is carried out assuming that the 2019 primary structural balance will be kept constant over the projection horizon. Potential output growth is assumed to evolve in line with country-specific paths derived on the basis of the T+10 production function extrapolation methodology agreed by the Output Gap Working Group (OGWG). Long-term interest rate converge to 3 per cent in real term at the end of the projections horizon. Inflation is measured trough the growth rate of GDP deflator which is assumed to converge to 2 per cent in 2022. The output gap closes linearly in 2022 starting from the level of 2019. The Stock-Flow adjustment is assumed equal to zero from 2019 onwards.

Moreover, the cyclically-adjusted primary surplus will stay constant at the level estimated for 2019 (equal to 1.4 percent of GDP) before considering the impact of age-related expenditures. On the basis of such assumptions, the Commission projects Italian public debt as a ratio of GDP to decrease only slowly, from 131.8 per cent of GDP in 2017 to 129.7 per cent in 2019 and 126.2 percent in 2027, at the end of the forecast horizon (Figure V.1).

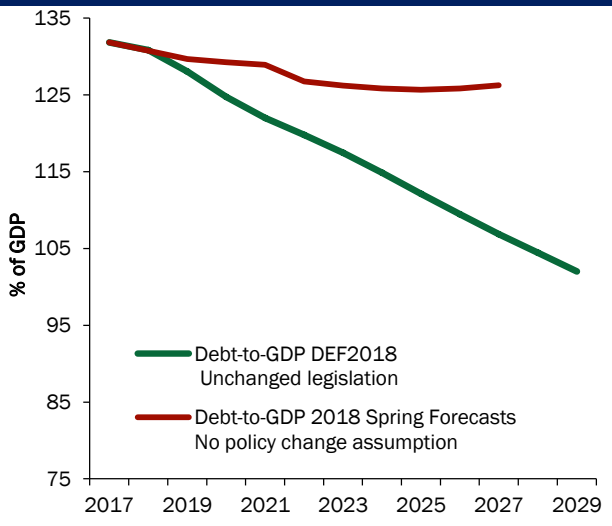
Similar deterministic scenarios for simulating the projected evolution of the debt-to-GDP ratio over the medium term have been carried out by the Italian government[17]. In the Italian exercise, the projection horizon is extended to 2029 and includes, for the years 2017 to 2021, the trend macroeconomic outlook as well as the current legislation fiscal targets set in the DEF 2018.

In line with the Commission approach, for the years beyond the forecasting horizon of the Stability Programme, i.e. after 2021, potential output growth moves in line with the country-specific paths derived on the basis of the T+10 production-function extrapolation methodology agreed by the Output Gap Working Group (OGWG). On the basis of such assumptions, real GDP growth is projected to be on average equal to a still-low 0.6 percent over the period 2022-2029.

The cyclically primary surplus will stay constant at the level estimated for 2021 (equal to 3.6 per cent of GDP) before considering the impact of age-related expenditures. On the basis of such assumptions, public debt as a ratio of GDP is projected to decrease steadily from 131.8 per cent in 2017 to 122.0 per cent in 2021 and 102.0 per cent in 2029, the final year of the forecasts horizon.

Figure V.2 shows that under both the Commission and the MEF scenario, the Italian debt-to-GDP ratio over the medium term is, expected to decrease. Given that both scenarios share the same methodology for extrapolating real and nominal output growth and only slightly different results of their perspective evolution, the slower reduction in the debt-to-GDP ratio according to Commission projections can be attributed to a lower primary surplus in 2019 resulting from the no-policy-change assumption. In fact, the Commission does not include in its estimates the VAT increases enacted in the 2018 Budget. Unless amended via new legislation, these tax hikes will enter into force in 2019 and 2020.

FIGURE V.2: DETERMINISTIC MEDIUM-TERM PROJECTIONS OF THE DEBT-TO-GDP RATIO



Source: MEF elaborations on 2018 Stability Programme and 2018 Commission services Spring forecasts.

The Italian government is confident that, based on the 2018 Budget, the MTO will be reached in 2020 and the debt-to-GDP ratio will fall in 2018 -2021.

[17] For more information please refer to the section IV.2 of the DEF 2018 (http://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2018/DEF_2018_-_Sez.1_-_Programma_di_Stabilitx.pdf)

V.2 FISCAL SUSTAINABILITY IN LIGHT OF AN AGEING POPULATION

Italy's public finances are considered at high risk over the medium term also on the account of the results of the S1 sustainability indicator which, according to the current definition, measures the gap between the current fiscal primary balance position, expressed in structural terms, and the one required to achieve the debt target of 60 percent of GDP in 2032.

Calculated on the basis of the data underlying the 2018 DEF, the S1 indicator would point out to a required fiscal adjustment of the primary balance amounting to 6.4 percentage points of GDP, whereas, on the basis of the 2018 Spring Forecasts, the adjustment would rise to 7.6 percentage points of GDP.

Comparing the current estimates with the values published in the previous planning documents or Commission reports, the S1 index has been deteriorating significantly. Such deterioration, however, cannot be solely explained by the updating of the government's budget objectives but it entails also: 1) the change in the definition of such indicator carried out by the Commission at different points in time, which made the S1 requirements for countries with high, although sustainable, initial debt more and more ambitious; 2) the change in the initial budgetary projections expressed in structural terms as a result of the rapid closure of the output gap; 3) more recently, the worsening of the medium and long term macroeconomic projections for Italy carried out in the occasion of the 2018 Ageing Report.

The Government is thus of the opinion that the S1 indicator cannot be considered a fully reliable index to assess whether a country is experiencing sustainability risks.

TABLE V.1: DEBT SUSTAINABILITY INDICATORS (P.P. OF GDP)

	DEF 2018	2018 Spring Forecasts	DSM 2017	DEF 2017	2015 Sustainability Report	DEF 2016	DBP 2015
S1 Indicator	6.4	7.6	6.7	3.9	4.2	3.9	1.7
Of which:							
Initial Budgetary Position – Debt stabilizing factor	-1.6	0.3	0.4	-2.8	-1.4	-2.8	-3.1
Cost of Delay in the Adjustment	1.4	1.4	1.1	0.7	0.7	0.7	0.0
Debt requirement (convergence to 60% of GDP)	5.6	5.3	5.1	5.6	5.1	5.6	4.7
Ageing Costs	1.0	0.6	0.1	0.3	-0.2	0.3	0.1
S2 Indicator	0.2	2.2	0.6	-1.9	-0.9	-1.9	-2.4
Of which:							
Initial Budgetary Position – Debt stabilizing factor	-1.3	0.9	0.5	-2.0	-0.8	-2.0	-2.4
Ageing Costs	1.5	1.3	0.1	0.1	-0.1	0.1	0.0

Source: MEF elaborations on 2018 Stability Programme and Commission reports.

With reference to the issue of the changing definition of the S1 indicator, it must be noted that, according to the initial methodology of calculation presented in the Fiscal Sustainability Report[18] of 2009, the objective of S1 was to measure the gap between the current fiscal position expressed in structural terms and the one required to achieve the debt target of 60 percent of GDP in 2060, taking into account the impact of expenditure linked to ageing. The Report stated that the choice of the debt-to-GDP target for S1 to 60 per cent of GDP was in line with the Treaty threshold and, above all, that the target year of 2060 had been chosen to be far enough in time to allow to analyze the budgetary impact of ageing, while remaining within a horizon within the reach of current taxpayers and policy makers.

In the Fiscal Sustainability Report[19] of 2012, the definition of S1 was further modified by the Commission. In the European Commission's intentions, S1 had to be designed as a medium-term debt sustainability indicator in which the required fiscal effort, taking into account the impact of expenditure related to ageing, should have been calibrated so that the debt threshold of 60 percent of GDP would be reached much earlier, i.e. in 2030. According to the new S1 indicator definition, the fiscal effort was to be introduced in a linearly increasing fashion from the last year of the Commission services forecast horizon (which at the time was 2014) to 2020 (the so-called cost of delay) and then maintained constantly for the next ten years so that to hit the debt-to-GDP threshold of 60 percent in 2030.

In the 2015 Fiscal Sustainability Report[20] of January 2016, the methodology for the derivation of S1 was once again substantially changed. In the 2012 Sustainability report the fiscal effort to reach a debt level of 60 percent of GDP in 2030 (target year) had to be increased linearly in 6 years (from 2014 to 2020) and maintained constant for 10 years (from 2020 to 2030). On the contrary, in subsequent reports, the fiscal effort had to be carried out linearly for 5 years starting from the final year of the Commission forecasts (i.e. in the 2018 Spring Forecasts from 2020 to 2025) and maintained constant only for 7 years (from 2025 to 2032). Against this framework, it is of some importance to note that, by construction, the results of the S1 indicator automatically worsen when the distance from the target year decreases.

Whatever the motivations, the changes in the S1 definition introduced by the Commission in 2012, by halving the length of the projection horizon from 2060 to 2030 and subsequently reducing the distance to the target year to only 7 years, increased the fiscal effort required to achieve the 60 percent of GDP debt threshold, making the task particularly hard for countries, like Italy, that had a high (but sustainable and expected to decline) debt-to-GDP ratio.

As stated above, the S1 indicator is also highly dependent on the level of the cyclically-adjusted primary balance in the initial year. In this respect, a large share of the worsening of the S1 indicator is due to the no-policy change assumption made by Commission in the 2018 Spring Forecasts which, as already mentioned, does not include the impact of the

[18] European Commission, 2009, 2009 Sustainability Report, EUROPEAN ECONOMY n. 9, also available at: http://ec.europa.eu/economy_finance/publications/pages/publication15998_en.pdf

[19] European Commission, 2012, 2012 Sustainability Report, EUROPEAN ECONOMY n. 8, also available at: http://ec.europa.eu/economy_finance/publications/european_economy/2012/pdf/ee-2012-8_en.pdf

[20] European Commission, 2016, 2015, Fiscal Sustainability Report. EUROPEAN ECONOMY and 2016 Debt Sustainability Monitor, Institutional Papers 47 (https://ec.europa.eu/info/publications/debt-sustainability-monitor-2016_en)

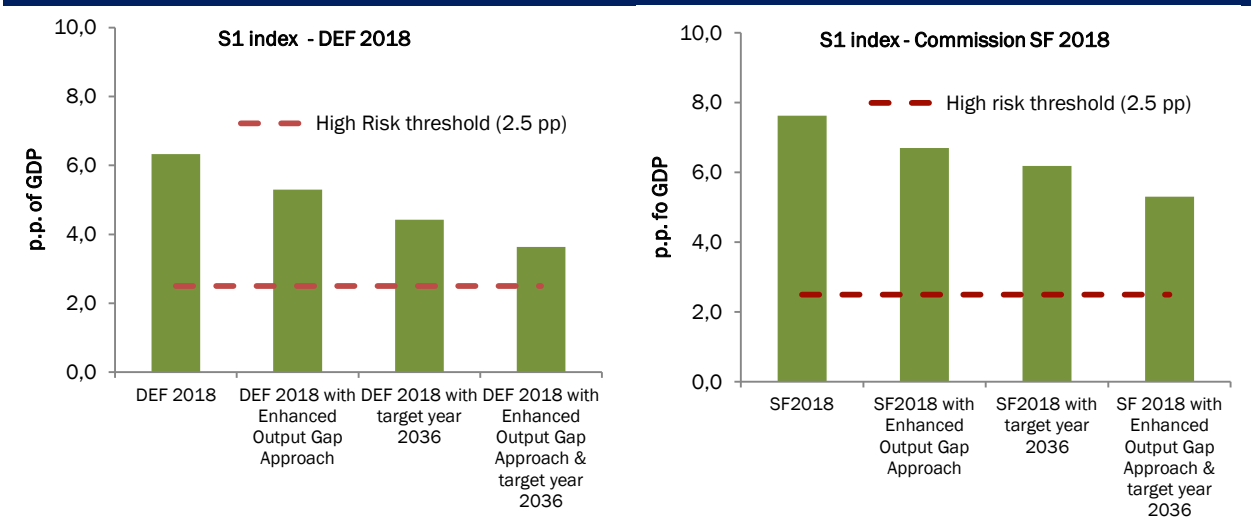
safeguard clauses. The exclusion of such item contributes to reduce the structural primary surplus by at least 0.7 percent of GDP, worsening significantly the initial budgetary conditions and the S1 index.

In addition, the structural primary balance is further reduced by the estimated cyclical conditions in 2019. Indeed, as the output gap of 2019 reaches a positive value of 0.6 per cent of potential, the cyclical component contributes to reduce the structural primary balance by 0.3 per cent of GDP in the 2018 Spring Forecasts.

In order to grasp the volatility of the S1 index, figure V.2 presents its sensitivity to the change in the underlying cyclical conditions, by calculating the structural primary balance of 2019 on the basis of the output gap obtained through the MEF enhanced methodology presented in Chapter IV, and to a change in its definition by applying the algorithm of S1 as defined in the 2012 Sustainability report, i.e. allowing the primary balance to improve linearly on the basis of an initial five-year linear fiscal adjustment and to remain constant for 10 year so as to convergence to the 60 percent of GDP in 2036 instead of 2032 as currently envisaged.

The sensitivity exercise on S1 has been carried out on the basis of the DEF 2018 medium term scenario as well as on the basis of the 2018 Commission services Spring forecasts. As it is possible to grasp from Figure V.3, lengthening the target year for the S1 indicator to 2036 together with a more balanced assessment of the cyclical condition in Italy, would contribute to almost halve the fiscal adjustment required to converge to the debt threshold of 60 per cent of GDP.

FIGURE V.3: SENSITIVITY OF THE S1 INDEX TO CHANGES IN THE INITIAL CYCLICAL CONDITIONS AND TO CHANGES IN THE TARGET YEAR



Source: MEF elaborations on 2018 Stability Programme and 2018 Commission services Spring forecasts.

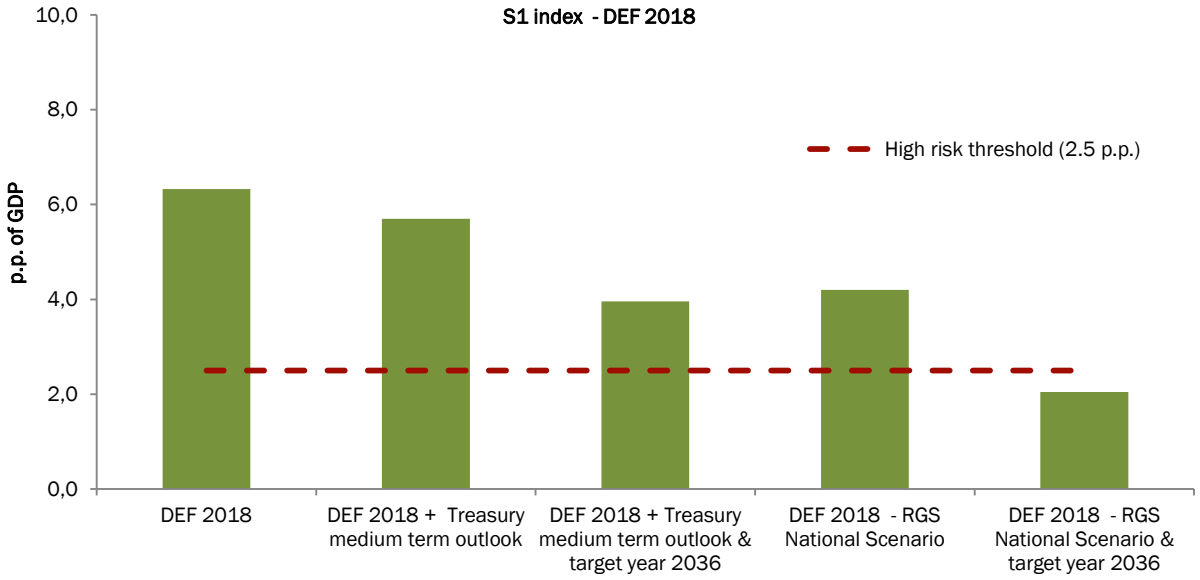
Finally, as stated above, the deterioration of the S1 indicator is also due to the update of the medium and long term growth prospects for Italy. The EPC-AWG baseline scenario underpinning the 2018 Ageing Report[21] revises down sharply the real GDP growth projection for Italy compared to the previous 2015 projections. Due to a reduction in the net migration

[21] See the Report https://ec.europa.eu/info/sites/info/files/economy-finance/ip065_en.pdf

flow, coupled with muted TFP prospects over the medium term, over the period 2016-2070, Italy's real GDP growth would average 0.7 per cent vis-à-vis 1.4 per cent in the 2015 scenario. In particular, real GDP growth over the next 12 years is projected to be very low and close to a meagre 0.3 per cent on average.

In order to assess the reaction of S1 to changes in medium term potential output growth scenarios, the indicator has been recalculated under alternative growth assumptions, namely the Italian Treasury medium term outlook[22] and the RGS long-term national scenario[23] (Figure V.4).

FIGURE V.4: SENSITIVITY OF THE S1 INDEX TO CHANGES IN THE MEDIUM TERM GROWTH PROSPECTS AND TO CHANGES IN THE TARGET YEAR



Source: MEF elaborations on 2018 Stability Programme and 2018 Commission services Spring forecasts.

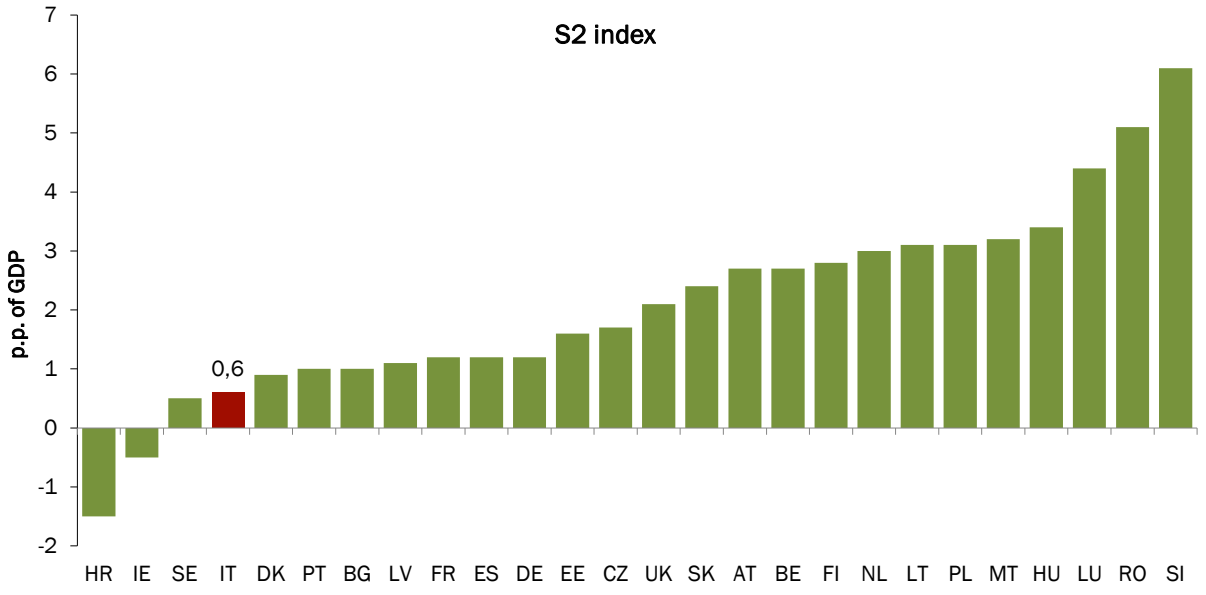
[22] The Italian Treasury medium term outlook assumes: i) that the growth in hours worked per person employed, starting from 2021 will growth a zero rate and will not decline. This assumption reflects the better productivity of work that would be achieved following the labor market flexibility measures of the Jobs Act together with the greater investments incentivized by the Industry 4.0 program; ii) as of 2024, the ratio between investments and potential output converges in 2028 to 22 per cent equal to the 2007 pre-crisis level. This hypothesis reflects the major investments incentivized by the Industry 4.0 program; iii) the structural NAWRU anchor panel estimate excludes from the explanatory variables the rate of replacement of unemployment benefits as the series shows an anomalous trend for Italy. The anchor stands at 8.35 per cent vis-à-vis 9 per cent (2017 Spring Forecast data) and 10 per cent (Autumn Forecast data that most suffers from the abnormal replacement rate data). On the basis of this assumptions, potential output is projected to grow over the period 2021-2028 by 0.8 per cent on average vis-à-vis the European Commission T+10 medium term scenario which, instead, assumes a low 0.3 per cent average growth over the same time horizon.

[23] Ragioneria Generale dello Stato (RGS) is the accounting division of the Economy and Finance Ministry. The long-term projections of the RGS national scenario are based, as far as the demographic assumptions are concerned, on the ISTAT median scenario, with base year 2016. This scenario includes: i) an annual net flow of immigrants equal, on average, to 152 thousand units with a slightly decreasing profile; ii) a level of life expectancy at 2070 equal to 86.5 years for men and 90.6 years for women; iii) a total fertility rate to 2070 equal to 1,59. With regard to macroeconomic variables, for the two-year period 2016-2017, the scenario includes National Accounts data, whereas the for the four-year period 2018-2021 the macroeconomic outlook of the DEF 2018 has been adopted both at constant prices and at current prices. For following period, the RGS national scenario assumes a growth rate of productivity gradually increasing from 0.4 percent in 2020 to a peak of 1.7 percent in 2045 converging to 1.5 in the last part of the projection horizon. The activity rate, for the 20-64 age cohort increases from 68.6 percent in 2015 to 78.1 percent in 2070, while, at the end of the forecast period, the unemployment rate converges to 5.5 percent. Based on these demographic and macroeconomic assumptions, the growth rate of real GDP is around 1.2 percent average per year, in the long run, with a profile tending to increase in the first decade, decreasing in the next twenty years and slightly recovering in the last part of the projection period. For further details see RGS, 2017, Trends Report Medium-Long Period of the Pension and Social-Health System, n.18.

In line with the previous sensitivity analysis, more positive medium term growth prospects would reduce the fiscal requirements of S1 from a minimum of 0.5 percentage points under the Treasury medium term outlook to almost 1/3 under the RGS National Scenario. Using the alternative macroeconomic assumptions, extending the target year for the S1 indicator to 2036 would almost halve the fiscal adjustment required to converge to the debt threshold of 60 per cent of GDP in the Treasury medium term outlook. In the case of the RGS National Scenario, the S1 indicator would be reduced by almost 2/3 with respect to the results of the DEF 2018, reaching a value of 2 percentage points, which is well below the high risk threshold identified by the Commission.

As for the indicator of long-term sustainability S2, the Commission confirms that Italy's debt is one of the more sustainable in the long term among the EU countries. The gap relative to the primary balance required to stabilize debt at the current level and pre-finance all the future increases in age related expenditures is slightly positive (0.6 percent of GDP according to the Commission) *vis-à-vis* much larger and positive values for most of the EU countries (Figure V.5).

FIGURE V.5: LONG-TERM FISCAL SUSTAINABILITY - S2 INDICATOR (P.P. OF GDP)



Source: European Commission, 2017 Debt Sustainability Monitor.

Liabilities emerging from the ageing of population have thus been offset by the pension reforms introduced over the past 20 years and the tight control on health and long-term care expenditures.

Furthermore, as shown in Table V.2, the 2018 Ageing Report projects for Italy a reduction of 1.7 percent of GDP in pension expenditures and a slight increase of 0.7 percent of GDP in health-care expenditures over the period 2016-2070. The pension projection is well below the EU and Euro area averages, while the health-care one is equal to the mean.

TABLE V.2: AGE RELATED EXPENDITURES (percent of GDP)		
Countries	Pension expenditures	Health-care expenditures
	Change 2016-2070 (% of GDP)	Change 2016-2070 (% of GDP)
BE	2.9	0.4
BG	1.4	0.3
CZ	2.8	1.1
DK	-1.9	1.0
DE	2.4	0.7
EE	-1.8	0.3
IE	1.6	1.0
EL	-6.6	1.2
ES	-1.5	0.5
FR	-3.3	0.5
HR	-3.8	0.7
IT	**-1.7**	**0.7**
CY	-2.3	0.4
LV	-2.6	0.6
LT	-1.7	0.4
LU	8.9	1.2
HU	1.5	0.8
MT	2.9	2.7
NL	0.6	0.6
AT	0.5	1.3
PL	-1.0	0.8
PT	-2.2	2.4
RO	-0.7	0.9
SI	3.9	1.0
SK	1.2	1.2
FI	0.6	0.8
SE	-1.2	0.7
UK	1.7	1.4
NO	2.1	1.2
EU	-0.5	0.7
EA	-0.4	0.7

Note: 2018 European Commission, Ageing Report.

VI. CONTINGENT LIABILITIES AND RESILIENCE

VI.1 PUBLIC DEBT STRUCTURE

General government debt consists primarily (84 percent) of central-government securities. In 2017 further progress has been made on improving the resilience of government debt to financial risks (such as those due to the refinancing of public debt, interest rate, inflation and exchange rate risks).

The stock of government securities rose by nearly 39 billion euros in 2017. Even so, the share of Treasury Bills (BOTs)[24] decreased from 5.74 percent at the end of 2016 to 5.59 percent at the end of 2017. The CTZs' share[25] remained stable, moving from 2.12 percent to 2.13 percent over the same period, while the stock of fixed-rate BTPs[26] grew from 69.63 to 71.78 percent. The stock of nominal and inflation-linked BTPs with a residual maturity equal or longer than 10 years remained around 24 percent of the total.

In terms of flows, in 2017 the share of total debt issuance of bonds with a maturity equal or longer than 10 years was kept almost unchanged from 2016 at around 19 percent, a remarkable achievement if one considers that 2016 had seen the launch of two new tenors (the 20 and the 50 years)

Refinancing risk management thus improved: the average life of the total stock of government securities increased from 6.76 years in 2016 to 6.9 years in 2017, following a pattern that began in 2015. The share of securities maturing in the next year decreased from 17.3 percent at the end of 2016 to 15.2 percent at the end of 2016 (in contrast with the pattern of last year), while the share of paper coming due in the next 5 years came down from 54.3 percent at the end of 2015 to 53.3 percent at the end of 2016.

The exposure to interest rate risk and inflation risk was further reduced: in 2017 the quota of nominal floaters (CCTeus with a maturity between 5 and 7 years linked to 6-monh Euribor rate and CCT with a maturity of 7 years linked to 6-month T-bill auction rate) decreased at the margin from 7,21 percent to 6.97 percent[27] whereas that of BTP€I and BTP Italia (real bonds linked, respectively, to European and Italian inflation) went down from 12.71 percent to 11.18 percent due mainly to an only partial refinancing of the BTP Italia large redemptions (following last year's pattern). Accordingly, the total share of floating debt was brought down from 20 percent at the end of 2016 to around 18 per cent at the end of 2017.

Focusing on the interest rate risk, it is of some importance to notice that *Average Refixing Period (ARP)*[28] increased marginally from 5.64 to 5.76 years, therefore showing a

[24] T-bills, i.e. government paper with a maturity at issuance equal or shorter that 1 year.

[25] CTZ are zero coupon paper with a 2-year maturity at issuance.

[26] BTP are the standard fixed-rate nominal bonds with a maturity range from 3 to 50 years at issuance.

[26] Inflation linked BTPs are bonds linked to Euro area inflation with a maturity range from 5 to 30 years at issuance.

[27] However in March 2017 the last CCT, the nominal 7 year floaters linked to the 6-monh Treasury Bill auction rate came due, therefore the stock of floaters at the end of 2017 was made only of CCTeus, the floaters indexed to the 6-month Euribor).

[28] The average refixing period ARP) reflects the average time still to elapse (without discounting the flows) before the debt structure incorporates the new market rates. For real or nominal fixed-rate securities, the indicator is based on the

slightly better exposure to potential interest rate shocks coming from fixed income markets. The duration of total stock of government securities remained stable, moving from 5.54 to 5.50 years, part of the decrease being due to an increase of market interest rates[29].

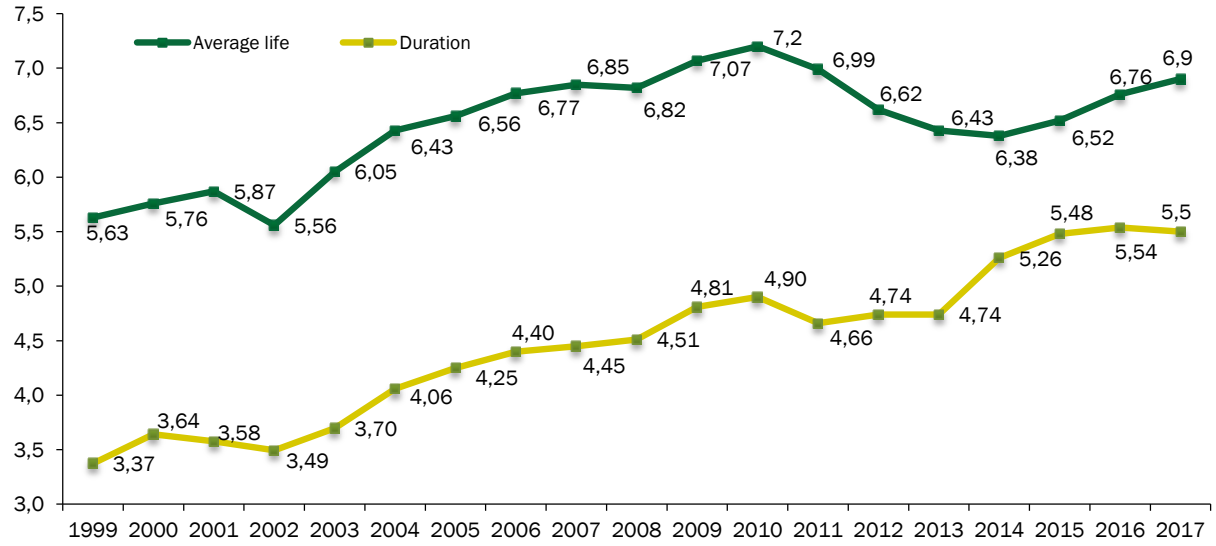
The evolution of the total debt interest burden to market shocks provides another way to look at how the exposure to interest rate risk has been managed over the year.

As shown in the 2018 Economic and Financial Document, (DEF 2018, par. IV.1), a permanent shock of 100 basis points to the whole yield curve would impact the interest debt burden for just 0.11 percent of GDP in the first year, 0.25 points in the second year, 0.36 points in the third year and 0.45 in the fourth year, these numbers showing an improvement compared to last year's results.

Finally, the exposure to exchange rate risk in 2017 remained negligible and even reduced compared to 2016: at the end of the year the share of debt issued in foreign currency unhedged[30] was 0.11 percent, compared to 0.13 in the previous two years.

Short term rates were largely negative throughout 2017 (reaching a minimum of -0.4 for the 1 year T-bill) and nearly all two-year paper placements were also carried out at negative rates (the average rate going from -0.031 percent in 2016 to -0.124 percent in 2017). The three-year BTP auctions, however, were generally priced at rates above zero, the average rate moving from 0.06 percent in 2016 to 0.23 percent in 2017. The market 10-year rate moved down from around 1.8 percent at the start of the year and remained roughly stable throughout 2017.

FIGURE VI.1 – AVERAGE LIFE AND FINANCIAL DURATION OF GOVERNMENT SECURITIES OUTSTANDING



Source: MEF

residual life of each security, whereas for variable-rate securities, the indicator is based on the time to elapse until the indexing of the next coupon. Each security is included in the weighted calculation for the nominal value outstanding.

[29] The duration measure is indeed affected also by the general level of interest rates in addition to the actual composition of debt.

[30] Large part of debt issued in foreign currency is indeed swapped back into euro.

Concerning the shape of the yield curve, a non-negligible rise in the slope of the 1-10 years segment was observed in 2017 (40 basis points on average). While the short end of the curve remained anchored by ECB policy(the deposit-facility rate has been at - 0.40 percent since March 2016), longer maturities were affected by a number of domestic and international geopolitical events, especially at the beginning of the year[31].

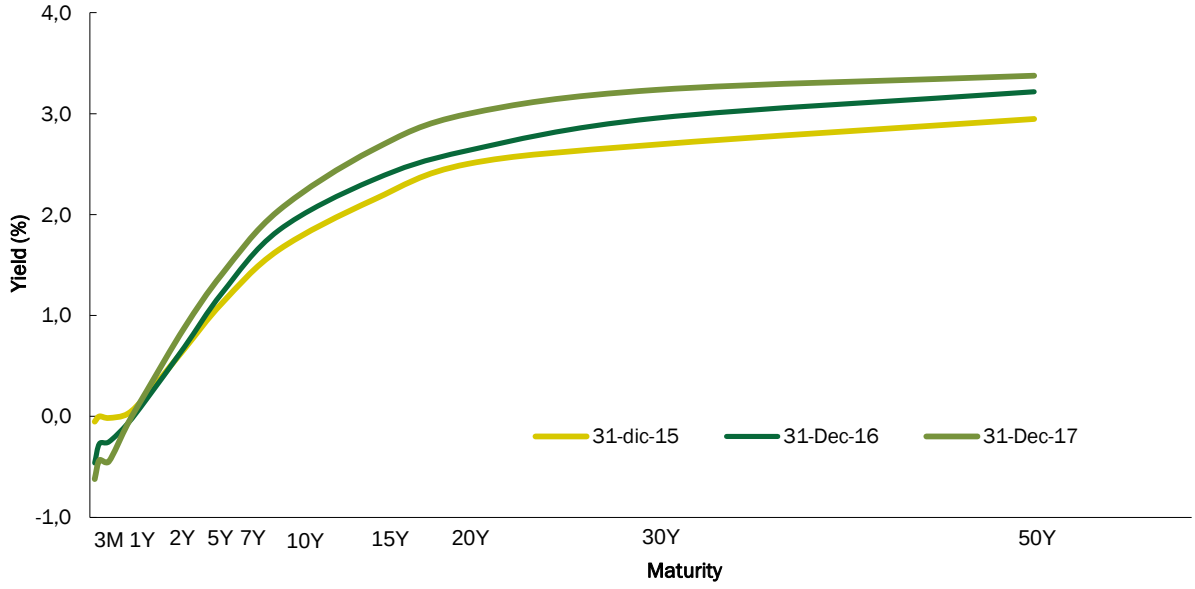
On the other hand, the slope of the 10-30 year segment remained quite stable, further reducing its volatility in the last quarter (114-124 basis points), showing a growing interest from investors on long-term Italian government securities, attributable to the very low interest rate environment and the very high liquidity standards of said securities in the secondary market. Particular consideration has to be given to the excellent performance of the new 50-year BTP, first introduced in the last trimester of 2016.

Despite periods of rather high volatility and a steepening of the intermediate part of the yield curve, the average cost at issuance at the end of 2017 remained very contained, 0.68 percent, only mildly above the 0.55 reached in 2016.

At the end of 2017 the amount of debt bought by the ECB was slightly above 340 billion euros (book value), a level reached through monthly purchases of around 9.6 billion on average from March 2015 to December 2017 and of around 3.6 billion starting from January 2018.

By tapping the long end of the market, in order to further improve the debt resilience to market risks, Italy gained in terms of reduction of the interest burden, albeit losing benefits in terms of the decline in the debt-to-GDP ratio.

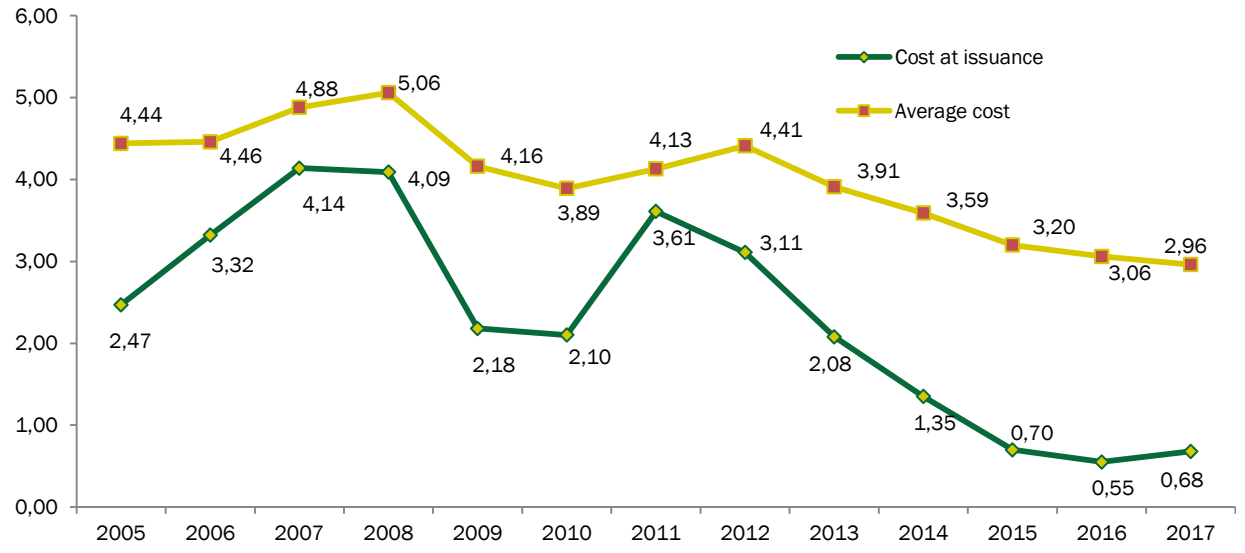
FIGURE VI.2 – EVOLUTION OF ITALIAN DEBT YIELD CURVE



Source: MEF.

[31] Amongst which: the outcome of the Italian Constitutional Referendum in December 2016, the French Presidential Elections and the possibility of an anticipated national elections in Italy (mentioned numerous times throughout the year).

FIGURE VI.3 – THE EVOLUTION OF THE DEBT AVERAGE COST AND THE COST-AT-ISSUANCE



Source: MEF.

As a result of these market trends and issuance policy, in 2017 the implicit cost of funding of the general government was 2.97 percent, down from 3.06 percent in 2016. If issuance activity in 2017 had been skewed towards shorter maturities, the marginal cost at issuance would have been even lower, pushing down also the average cost, but this policy would have left government debt more exposed to market risks in the future.

As already pointed out in the previous reports on Relevant Factors of May 2016 and of February 2017, the structure of government debt will protect Italy from interest rate shocks and other types of risks, but this obviously entails a higher cost of funding in the near term.

VI.2 FURTHER RISKS RELATED TO THE STRUCTURE OF PUBLIC DEBT FINANCING

Both the level and the changes in the share of short-term public debt (in percent of the total debt) provide an indication of increased/decreased refinancing risk (or roll-over risk) and vulnerability in relation to government's reliance on temporary market financing. In the European Commission's approach, those values would be examined in relation to a set of calculated critical thresholds of fiscal risks, according to the so-called signals' approach, so as to establish whether fiscal risks related to the structure of public debt financing may eventually emerge.

According to the Commission methodology for assessing debt sustainability, short-term debt above 6.6 percent may be considered at high risk of rollover whereas its yearly change should be considered highly risky if it records an increase above the threshold of 2.76 percentage points. On the basis of Eurostat figures, between 2015 and 2016 the share of short-term debt of Italy decreased from 14 to 13 percent. In 2017, according to the provisional data published by the Bank of Italy[32], the share moved further down by

[32] Supplemento al Bollettino Statistico – Finanza pubblica, fabbisogno e debito del 13 Aprile 2018. Tavola 8

approximately 1.7 percentage points. Accordingly, given the constant reduction pattern, possible risks of roll-over may only stem from the initial share.

Another index which may provide information on the extent to which the government may need to tap the bond market in the current and in future years is represented by the Gross Financing Needs (GFN). The European Commission 2017 Debt Sustainability Monitor presents projections of the GFN up till 2028. In these estimates, Italy appears as having the largest GFN in EU, amounting in 2017 to 24.4 percent of GDP (1.5 percentage points less than reported in 2016). However, such a measure appears to be somewhat overestimated as, for instance, the recent IMF Fiscal Monitor[33] reports for Italy a GFN for 2018 of 22.2 percent of GDP, in line with the 21.7 G7 average.

As shown in the previous section, Italy's public debt presents a high average term to maturity (average life) of 6.9 years (increased from the 6.76 of 2016) that compares favorably with those of other developed countries. In particular, according to the IMF, in 2018 the debt-to-average maturity (i.e. an indication of the amount of new issued bonds) will be 18.9 percent of GDP, in line with the average of 18 percent for G7 countries (Table IV.2).

Table IV.2: STRUCTURAL INDICATORS FOR THE DEBT IN 2018

Country	Average term to maturity, 2018	Debt-to-average maturity, 2018
AT	8.3	9.1
BE	9.4	10.8
DE	5.8	10.3
ES	7.0	13.9
FI	6.2	9.8
FR	7.4	13.1
IT*	**6.9**	**18.9**
NL	6.9	7.8
PT	6.2	19.4
SI	8.5	8.5
SW	4.7	8.1
UK	14.9	5.8
USA	5.8	18.6
JPN	7.7	30.8
AUS	7.4	5.6
CAN	5.4	15.9
G-7	6.9	18.0
G20 ADV.	6.9	17.2

Source: IMF Fiscal monitor - April 2018.
(*) Figures provided by national authorities.

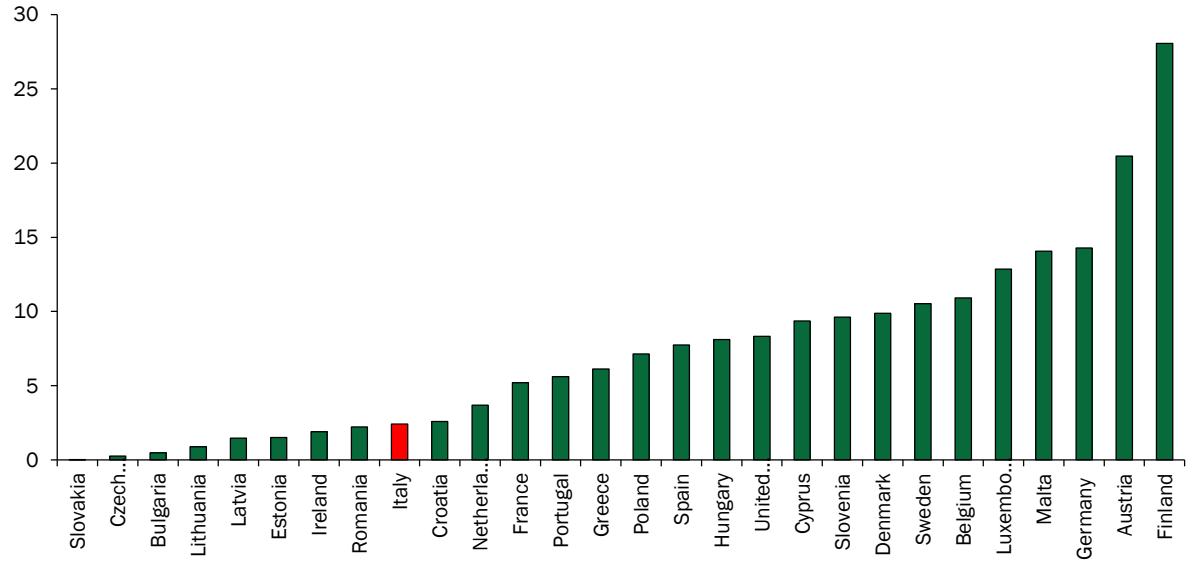
[33] IMF, 2018, Fiscal Monitor: Debt? Use it wisely, April 2018, available at: https://www.imf.org/en/Publications/FM/Issues/2018/04/06/fiscal-monitor-april-2018#Methodological%20&%20Statistical%20Appendix

VI.3 CONTINGENT LIABILITIES

In order to have a more comprehensive assessment of risks related to overall public debt sustainability, the data for government contingent liabilities, which are by nature potential and not actual, are also provided.

According to the January 2018 Eurostat release on contingent liabilities and non-performing loans in the EU Member States, in a comparison with main European partners, Italy presents one of the lowest stocks of government guarantees, at 2.4 percent of GDP in 2016. Italy's stock has slightly increased compared to 2015, due to guarantees in favor of SMEs and households. The guarantees related to the financial sector declined since 2012, thanks to lower guarantees issued in favour of the banking system (approximately 0.5 percent of GDP against a high of 5.3 percent in 2012).

FIGURE VI.4 - TOTAL STOCK OF GOVERNMENT GUARANTEES IN 2016 (% of GDP)

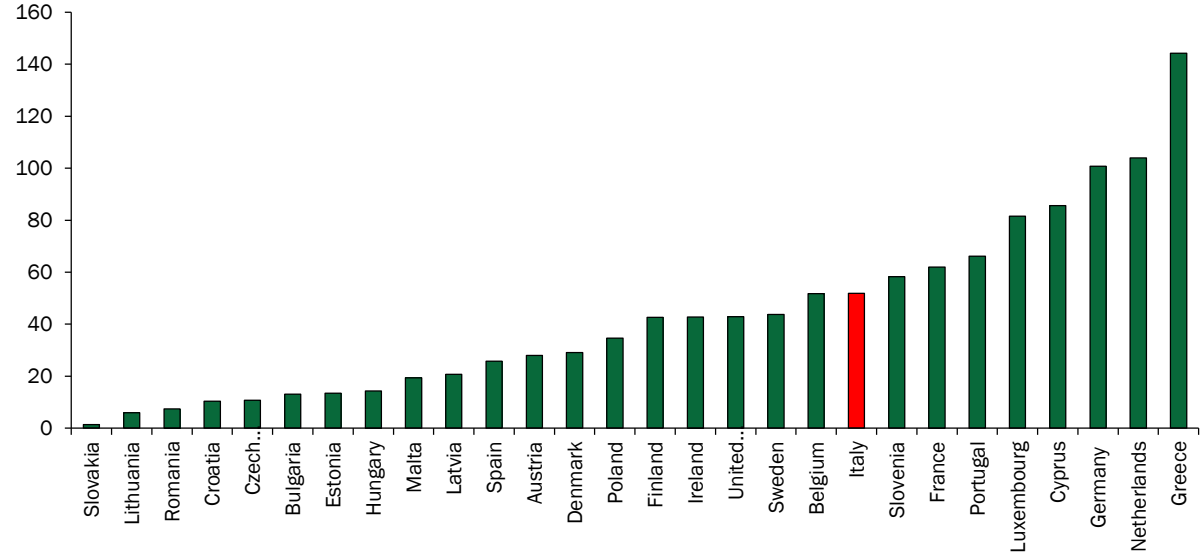


Source: Release No. 19/2018.

Moreover, the potential risk stemming from the Italian government's participation in corporations' capital are in line with the major economies of the European Union and significantly below the figures of other countries with a lower level of public debt, such as Germany and the Netherlands, whose liabilities of government controlled entities classified outside general government represent respectively 100.7 and 103.9 percent of GDP.

As explained in the Eurostat release, when comparing these data across countries it should be noted that: i) the main reason for the high level of these liabilities is that the data include government controlled financial institutions, among other public banks; ii) most of these liabilities consist of deposits held in these public banks by households and private or public entities; iii) financial institutions report high amounts of debt liabilities, however they also have, at the same time, a significant level of assets which are not captured by the data.

FIGURE VI.5 - TOTAL LIABILITIES OF GOVERNMENT CONTROLLED ENTITIES IN 2016 (% of GDP)



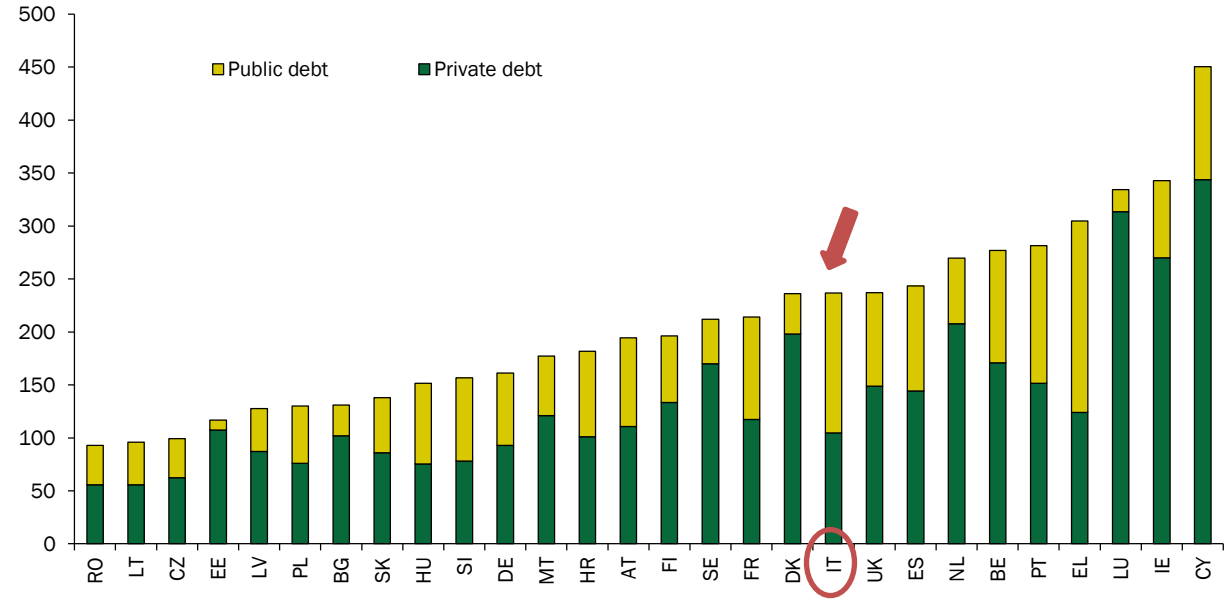
Source: Eurostat, Release No. 19/2018. For Czech Republic, Germany, France and Austria data of 2015; for Cyprus data of 2017.

Finally, unlike most other member states, Italy has the one of the lowest stock of non-performing loans (asset) of the general government, whose amount is stable at 0.01 percent of GDP since 2012. For many European countries showing a large stock of NPLs, the majority of these loans refer to loans of defeasance structures, which are classified in the general government sector.

VI.4 PRIVATE SECTOR DEBT

Firms' and households' financial conditions continued to improve in 2016. Latest data by Eurostat suggest that the private debt-to-GDP ratio (for both households and non-financial companies) decreased by 1.2 percentage points in 2016 with respect to the previous year. As a result, the total debt-to-GDP ratio (public and private) was reduced by 0.7 percentage points, as the debt of Italian households is still one of the lowest in the euro area. In 2016, household debt amounted to approximately 41 percent of GDP, 0.3 percentage points below the level of 2015 and lower than the euro area average (55 percent of GDP). With regard to non-financial corporations (NFCs), the ratio of firms' financial debt-to-GDP ratio amounted to 63.7 percent in 2016 (-0.9 percent points than in 2015), well below the euro area average (over 90 percent of GDP).

FIGURE VI.6 - PUBLIC AND PRIVATE DEBT DECOMPOSITION (% of GDP, 2016)



Source: Eurostat.

VI.5 PROPERTY PRICES

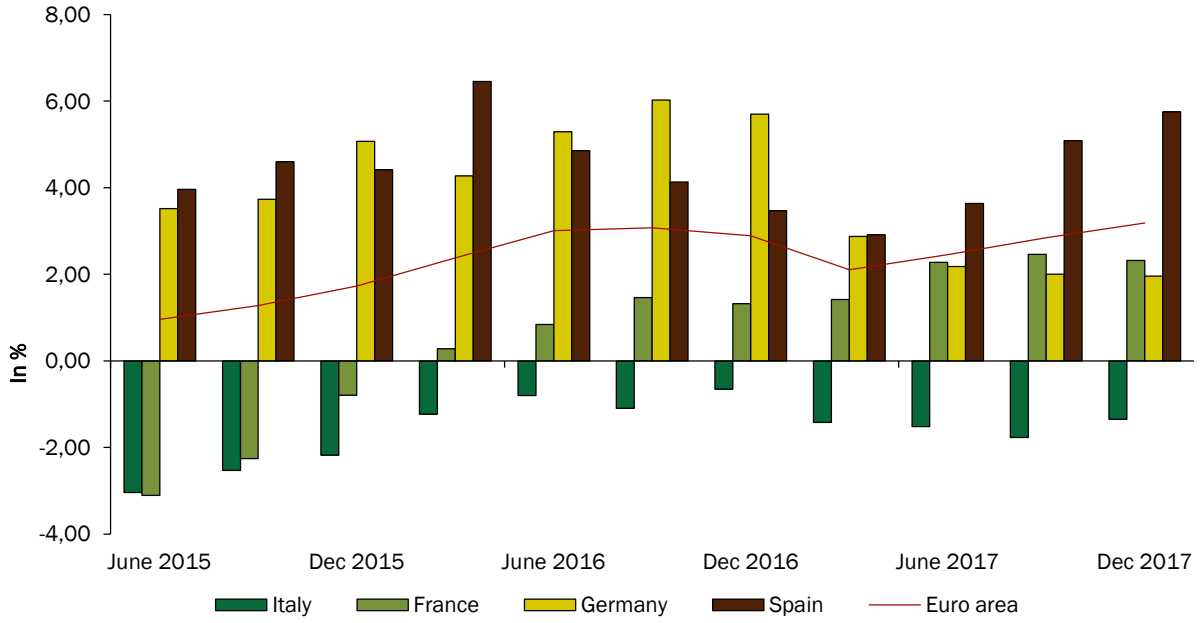
The property market began to recover in 2015 in terms of transaction volumes, and prices have stabilized. However, valuations remain attractive and, despite ultra-low interest rates, market conditions remain weak, unlike in most other European countries. Preliminary estimates[34] for the fourth quarter of 2017 show that the national house price index remained broadly stable compared with the previous quarter, with a slight decrease compared to the end of 2016. Specifically, new home prices were virtually unchanged with respect to the same quarter of 2016 and up 0.7 per cent quarter-on-quarter, while prices of existing dwellings remained stable compared to the previous quarter and decreased by 0.5 per cent on a year-ago basis.

An international comparison shows that the European situation remains fragmented. The real house price index[35] for the euro area exhibits a recovery in annual percentage changes from June 2017, driven by the German and the Spanish market (Figure VI.7).

On the other hand, real prices in France and in Italy show a slower path with yearly variations that in in both cases remain negative until the end of 2015. After that point, while France's home prices have been recovering, Italian prices keep declining in real terms. This negative trend, which is expected to reverse in the current year, suggests that Italy continues to lag the European property market cycle and is less subject to downside risks stemming from extended real asset prices.

[34] See: ISTAT, "House prices", April 2018.
[35] See: OECD, "Analytical house price indicators database".

FIGURE VI.7 - REAL HOUSE PRICE INDICES (in per cent, YOY)



Source: OECD.

VI.6 BANKS' CAPITAL RATIOS AND NPLS

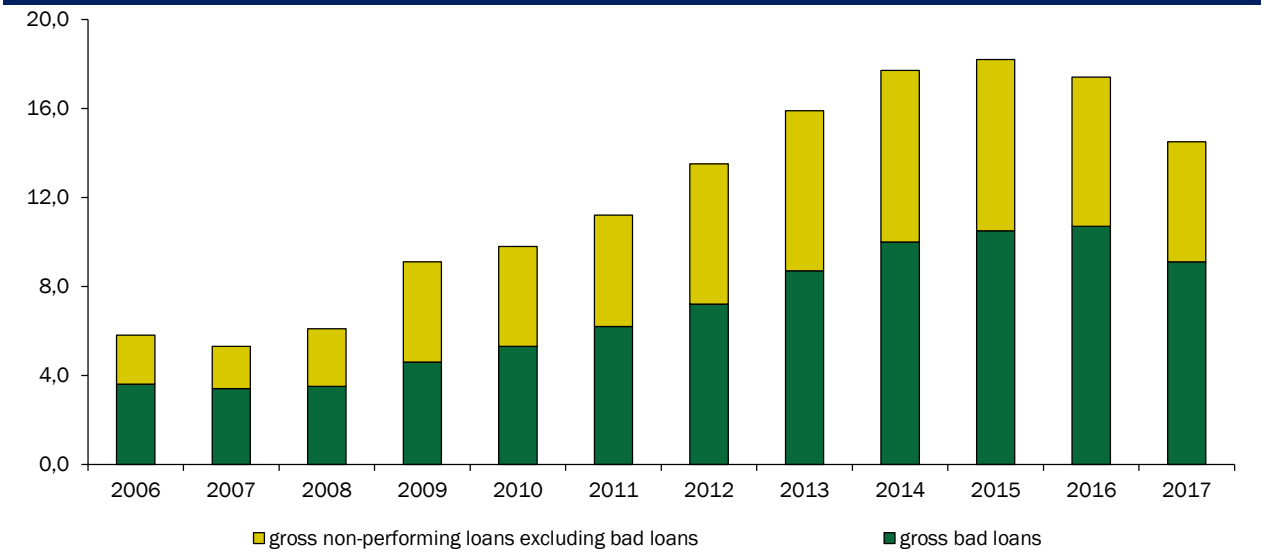
The latest data confirm that Italian banks' capital ratios continue to improve. At the end of 2017 the common equity tier 1 (CET1) was equal to 13.8 per cent of risk-weighted assets (RWA), up by around 130 basis points compared with June of the same year. On the other hand leverage ratios remain higher for Italian banks (6.0 per cent) than for European banks (5.5 per cent). The quarterly Bank Lending Survey reported that in the first quarter of 2018 credit supply standards slightly eased, in particular for new lending to firms and to households for home purchases and banks expect demand to strengthen further.

In terms of credit quality, most recent data[36] show that the new non-performing loans (NPLs) rate (i.e. the flow of exposures that become non-performing over the total of loans) has stabilized around 2 percent, close to pre-crisis levels. The stock of NPLs on banks' balance sheets keeps declining. In December 2017, Italian banks had gross exposures to bad loans of 178 billion euros, of which 133 billion pertained to systemically relevant institutions. Over the course of 2017, the ratio of NPLs to total loans declined to 14.5 per cent excluding provisions (Figure VI.8). As of December 2017, bad loans still had the higher relative weight (9.1 percent), but fell below 10 percent for the first time since 2014, while other nonperforming exposures were equivalent to 5.4 percent of customer loans.

[36] Bank of Italy, "Financial Stability Report", No. 1/2018.

Significant banks have already planned disposals of non-performing exposures and, by the end of this year, even the less significant banks with high NPL levels will be required to arrange operational plans consistent with the guidelines issued by the Bank of Italy in January 2018.

FIGURE VI.8 - NON-PERFORMING LOANS (IN % OF TOTAL LOANS)



Source: Bank of Italy.

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