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In-depth review for Italy

in accordance with Article 5 of Regulation (EU) No. 2011/1176 on the prevention and correction of macroeconomic imbalances

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

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On the basis of this in-depth review for Italy undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2022 Spring Package" (COM(2022)600 final) that:

Italy is experiencing excessive imbalances. Vulnerabilities relate to high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in financial markets, which carry cross-border relevance. Persistent low productivity growth has been a key factor behind Italy's protracted weak GDP growth, which has dampened government debt deleveraging, dented employment opportunities and impacted banks' balance sheets. The government debt-to-GDP ratio started to decline in 2021 and is forecast to further decline but remains a risk for fiscal sustainability, the financial sector and economic growth. Despite improvements in the labour market, low participation rates persist. Significant improvements have been achieved in reducing non-performing loans, although the sovereign-bank nexus reinforced over the COVID-19 crisis and remains a challenge. In addition, the banking sector may face challenges as the impact of the phasing-out of temporary support measures in response to the pandemic crisis fully unfolds. The RRP is addressing vulnerabilities, including by spurring competitiveness and productivity. Nonetheless, the growth-enhancing effect of investment and reforms is likely to take time to unfold and crucially depends on swift and sound implementation.

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1. INTRODUCTION

In 2021, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "excessive macroeconomic imbalances" in Italy. ([1]) These imbalances were related to the high level of government debt and weak productivity growth, which have cross-border relevance in a context of labour market and banking sector fragilities. The 2022 Alert Mechanism Report concluded that a new in-depth review (IDR) should be undertaken for Italy with a view to assess the persistence or unwinding of imbalances. ([2])

Italy's economy closed 2021 on a relatively solid footing, despite sizeable headwinds. ([3]) Real GDP grew by 6.6% and almost reached pre-COVID-19 levels in the final quarter of 2021, despite rapidly rising infection rates and surging energy prices. Real GDP growth is projected to slow to 2.4% in 2022 and 1.9% in 2023, as high energy prices and supply bottlenecks further exacerbated by Russia's military aggression against Ukraine continue to take a toll on economic activity. EU-supported investment and the still high stock of accumulated savings provide some safeguards against a severe growth slowdown going forward. The labour market recovered in 2021 on the back of temporary employment. Jobs growth is set to continue in line with slowing economic activity. Inflation is projected to accelerate further this year due to the pass-through of higher energy costs to consumer prices, before falling back in 2023. Energy and commodity prices are expected to remain high throughout 2022 and persisting supply bottlenecks continue to weigh on growth. In view of the extremely high geopolitical tensions related to the war in Ukraine, the outlook remains subject to high uncertainty and substantial downside risks.

This in-depth review presents the main findings of the assessment of imbalances. The assessment is backed by a thematic section on financial sector developments. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, assessments of structural issues made in previous IDRs and in the context of fiscal assessments are also considered if relevant. The MIP assessment matrix is published in the 2022 Country Report for Italy. ([4])

([1]) European Commission (2021), European Semester Spring Package 2021, COM(2021) 500 final.
([2]) European Commission (2021), Alert Mechanism Report 2022, COM (2021) 741 final.
([3]) Forecast data are from European Commission (2022), European Economic Forecast: Spring 2022, Institutional Paper 172.
([4]) European Commission (2022), Country Report Italy 2022, SWD(2022)616 final.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

Assessment of gravity, evolution and prospects of macroeconomic imbalances

Low productivity growth was the main factor behind Italy's weak growth performance in the decade prior to the COVID-19 pandemic. Over the period 2010-19, hourly productivity growth averaged 0.4% per year compared with an EU average of 1.2%. The capital-labour ratio, as measured by net fixed assets per unit of labour employed, stagnated when measured by hours worked or even gradually declined in terms of headcount employment. The high price for capital (relative to labour) reduced firms' incentives to invest in equipment and intangible assets, thus encouraging them to remain in labour-intensive traditional sectors. As a result, the key impediments of the Italian economy to higher productivity growth, notably the high share of low-productivity sectors combined with a small average firm size and low investment rates, became entrenched. Hence, the slowdown in productivity can be associated with a declining capital intensity (i.e. less capital deepening) and a slow diffusion of new technologies, such as information and communication technologies (ICT). Productivity remains particularly low in lagging regions.

The policy response to the COVID-19 pandemic offers prospects for structural productivity improvements. Labour productivity in terms of hours worked rose sizeably in 2020, likely influenced by a compositional effect, as the reduction of hours worked in small, less productive firms was relatively more pronounced than in larger, more productive firms with higher capital endowments. This effect partly reversed in 2021, when labour productivity declined and hours worked increased, albeit not yet to the level of 2019. However, increasing investment since 2015, only shortly but sharply interrupted by the pandemic in 2020, and policy measures included in Italy's Recovery and Resilience Plan (RRP), in conjunction with Cohesion Policy Funds, are expected to spur productivity in the medium term. In particular, substantial investment in skills, innovation and digitalisation as well as reforms of the public administration, the judicial system and insolvency framework are set to contribute to an efficient allocation of physical and human capital. By contrast, the fact that many companies have higher debt than at the outset of the pandemic risks curtailing their ability to invest in productivity-enhancing technology, and school and university closures might have a long-term impact on income and productivity growth. Private and public investment in key areas such as intangibles and education is still relatively low.

Italy's high level of public debt remains a risk for fiscal sustainability, the financial sector and economic growth. The high sovereign financing needs to roll over existing debt and to service interest payments make Italy strongly dependent on financial markets' risk perceptions, with potential spillovers to the domestic financial sector, given its high exposure to the sovereign. The low interest rate environment, the growing average maturity of outstanding debt and the Eurosystem's increased purchases of government securities have reduced fiscal sustainability risks, but sovereign financing conditions are expected to become less favourable with a less accommodative stance of monetary policy. Furthermore, high debt servicing costs limit the scope for growth-enhancing expenditure. The Commission's fiscal sustainability assessment shows that Italy faces high fiscal sustainability challenges over the medium term and medium challenges over the long term. ([8]) However, the reforms outlined in Italy's RRP are expected to have a substantial positive and persistent growth impact in the coming years, which, ceteris paribus, should strengthen debt sustainability.

Italy's government debt started to decline in 2021, albeit from a high level. Italy's public debt ratio in 2019 stood at 134.1% of GDP, high in a euro area comparison, partly due to persistently weak growth. The pandemic-related emergency policy measures and the sharp drop in GDP raised the debt ratio to 155.3% of GDP in 2020. The subsequent economic recovery boosted economic output and government revenues and public debt fell back to 150.8% of GDP in 2021. Italy's public debt ratio is projected to gradually decline to 146.8% of GDP by 2023 along with the expected economic growth, low financing

([8]) See European Commission Country Report on Italy for the latest results and the 'Fiscal Sustainability Report 2021', Institutional Paper 171, 25 April 2022 for methodological details.

costs and lower primary deficits. The expected budgetary improvements stem from a gradual phasing out of emergency measures and the projected economic growth, which are expected to more than offset the deficit increasing impact of permanent measures introduced in recent years.

The labour market continues to face structural challenges with low participation rates, regional and gender disparities, and high youth unemployment. Participation rates, especially among women, have been rising from albeit very low levels in the years prior to the pandemic and are about 13% below the EU average (15 to 64 years). The unemployment rate of women in 2021 was about two percentage point higher than for men (10.6% vs 8.7%). Youth unemployment dropped from its 2014 peak of 42.7% to 29.7% in 2021, owing largely to the increase in temporary employment of young people. The employment rate (15-64 years) records a substantial regional gap, between 66.4% in the North and 44.8% in the South (Mezzogiorno).

The labour market weathered the pandemic shock but recent job gains are largely driven by temporary employment. Headcount employment, in particular jobholders with permanent contracts, were effectively protected by short-time work schemes and the drop in employment was contained in 2020. The job market recovered in 2021, with surging temporary employment (9.7%) being the main pillar of employment growth. The unemployment rate fell between 2019 and 2021 from 9.9% to 9.5%. However, activity and employment rates, in particular of women and young people, remain markedly below the EU average. Moreover, the size of the shadow economy in Italy, albeit on a falling trend, was estimated at 11.3% of GDP in 2019 ([9]) reflected by widespread undeclared work. Looking ahead, jobs growth is forecast to continue, as policy measures favour a more efficient functioning of the labour market and are also expected to lift labour supply and promote labour market transitions.

In 2021, the banking sector restored its profitability and made significant progress in reducing legacy non-performing loans. Banks' profitability recovered to pre-pandemic levels, registering a return-on-equity of 5.8% in Q3 2021, mainly due to lower loan-loss provisions. Since Q4 2020, the CET1 ratio for Italian domestic banks slightly declined to 15.4 % in Q3 2021, but remained above the pre-pandemic level of 14%% in 2019. The legacy stock of non-performing loans (NPLs) continued to decline, with the gross NPL ratio falling to 4% in Q3 2021, from 5.6% in Q3 2020 and from the pre-pandemic level of 6.7% (at the end of 2019). However, the rising share of loans that show a significant increase in credit risk (Stage 2 loans) underlines the need for close monitoring. Moreover, the full impact ([10]) of the pandemic on asset quality will likely become visible only with a certain time lag, once state-support measures are being fully phased-out and granted moratoria have expired. Following three prolongations, 83% of approved moratoria had expired by 31 December 2021 and the total volume of loans with non-expired moratoria (i.e. legislative and voluntary moratoria granted by banks) amounted to EUR 44 billion. Risks also persist that potential second-round effects on economic growth from Russia's unprovoked invasion of Ukraine could lead to further vulnerabilities associated with private sector debt (see box 2.1).

Since the beginning of the pandemic, Italian banks had increased their exposure to domestic sovereign. According to ECB data, Italian banks' holdings of Italian sovereign debt increased by EUR 71 billion since December 2019 and reached a peak at EUR 710 billion in September 2020, ([11]) before falling back to EUR 671 billion by December 2021. Sovereign exposure of the Italian banking sector remains high and sovereign debt accounted for 21.3% of total banking sector assets in December 2021. The 10-year sovereign bond yield increased by around 160 bps in the first four months of 2022 continuing the increasing trend since summer 2021. Bank of Italy estimates that the impact on banks' capitalisation of an upward shift in the sovereign yield curve would be limited. ([12]) However, the risks associated with the increased share of public guarantees on banks' balance sheets amplifies the sovereign-bank nexus, as illustrated in the thematic chapter. Finally, the Italian financial system remains predominately bank-based and despite some progress in recent years, access to non-bank finance remains underdeveloped and concentrated in northern regions.

([9]) Istat (2021), Economia non osservata nei conti nazionali, 18 October 2021.
([10]) In view of the pandemic's delayed impact on corporate solvency, the Italian Banking Association expects 3.8% of loans to become non-performing in 2022 (after 2.1% in 2021), implying a rise in the NPL ratio.
([11]) ECB BSI Data: Domestic exposure is calculated as the loans to the Government, plus the amount of government securities held by the banking system. The level of debt securities stood at EUR 410 bn in Q4 2021. See the thematic chapter for more granular information.
([12]) Bank of Italy, Financial Stability Report, 19 November 2021, p. 40.

Italian banks' exposure to Russia is contained but is amongst the highest in the EU, with total claims representing about 1.2% of Italian GDP. According to the latest EBA dashboard (Q1-2022), the exposure of Italian banks to Russian counterparts amounted to EUR 21.8 billion or 28.6% of the total EU exposure towards Russian counterparts at the end of December 2021. Italian banking groups increased operations on the Russian market since 2015, but are currently re-assessing their exposure to Russia (and Ukraine) and considering options to mitigate the risks associated with this exposure. However, the exposures to Russia appear small relative to the total assets and loan books of parent groups exposed to Russia. Even a full write-off of banks' investments in their Russian subsidiaries in an extreme scenario is expected to have only a moderate impact on the capital buffer at the group level (see also Box 2.1).

Assessment of MIP relevant policies

Italy has started to implement its Recovery and Resilience Plan and, if fully implemented, the measures are expected to spur competitiveness and productivity. The enabling law to reform the judicial system adopted in 2021 is set to enhance the efficiency of the judicial system provided further implementing steps foreseen in the RRP proceed on schedule. Moreover, additional resources are being deployed to clear the backlog of cases before the courts. The timeliness and greater predictability of legal decisions should make the Italian economy more attractive for foreign investment. Similarly, the measures on public procurement reform adopted in 2021 and the envisaged revision of the code of public procurement by 2022 are conducive to simpler and faster procedures for awarding public contracts and ultimately to the improvement of the business environment. A public administration reform planned for 2022 under the RRP has the potential to strengthen administrative capacity and reform public employment at all levels of government. Similarly, the government intends to remove barriers to competition in selected sectors in 2022 and has implemented the *Transizione 4.0 tax credit* in 2021, as part of RRF-supported measures to favour the digitalisation of business.

Reforms, including those in the Recovery and Resilience Plan, are expected to improve the efficiency of revenue collection and public spending in the medium term. The government maintained its emergency support for households and firms and further stepped up public investment in 2021. The reforms and investments included in Italy's Recovery and Resilience Plan are expected to help reduce the debt ratio by supporting GDP growth, enhancing revenue collection and tailoring spending. With the 2022 Budget, the government reduced the personal income tax rates for middle-income earners and the draft delegation law of October 2021 sketched out a general tax reform. Past reforms to bolster tax compliance have already mitigated the still high revenue losses from tax evasion. The RRP measures planned for 2022 are expected to further improve tax collection. On the expenditure side, the RRP envisages reinforcing spending reviews and completing the reform of fiscal federalism to increase transparency and encourage spending efficiency across all government levels. By contrast, the large number of guarantees granted during the pandemic increased the government's contingent liabilities and hence the risk of higher public spending in the next years. In addition, pension expenditure is projected to grow until 2026, in part due to the temporary early retirement scheme for the period 2019-2021 and prolonged to 2022 with stricter eligibility criteria, before the provisions of the 2011 pension reform are set to slow pension spending.

The RRP includes measures to increase participation rates and the government has extended the social safety net. The *National programme for the Guaranteed Employability of Workers* (GOL) and the *National Plan for New Skills,* adopted in 2021, have the potential to raise labour market participation and facilitate jobs transitions while reducing hysteresis effects, regional disparities and skill mismatches. Similarly, the 2021 reform of university degrees easing access to some professions as well as the envisaged 2022 reform of the orientation services in upper secondary schools are expected to facilitate students' transition from education to the labour market. However, lowering the entry barriers to the labour market more effectively, particularly for women, requires strengthening the provision of affordable quality early childhood education and care, as well as counteracting the effects of labour market segmentation on young people. The reform of the social safety net included in the 2022 budget law and detailed in the *Decreto Sostegni Ter* extends inter alia the sectorial coverage of short-time work schemes. While this measure is welcome, the reform does not fully address one of the major structural shortcomings of short time work schemes', namely the focus on the protection of specific jobs instead of workers. The impact of the reform will in part depend on the strengthening of regional public employment services as part of the GOL reform. The adoption of the three-year plan 2020/2022 to

combat labour exploitation in the agricultural sector (*Piano triennale di contrasto allo sfruttamento lavorativo in agricoltura e al caporalato 2020/22)* and the RRP-sponsored National Plan tackling undeclared work across all economic sectors set to be adopted in 2022 might contribute to reduce irregular employment and the size of the shadow economy.

The extension of previous measures and the steps made for reforming the insolvency framework continue supporting the improvements made in addressing NPLs. NPL disposals and the dynamic secondary market of impaired assets have supported the reduction in non-performing exposures by the Italian banking sector. The government also extended the state-supported NPL securitisation scheme ("*Garanzia sulla Cartolarizzazione delle Sofferenze*" – GACS) and other emergency measures ([13]) until June 2022. The loan moratoria and tax credit for NPL disposal have been phased out at the end of 2021, as discussed more in detail in the thematic chapter, and the next two years will be an important test for the resilience of the Italian banking system. Furthermore, the implementation of the RRP investments in energy efficiency and building renovations, may have a positive impact on the recovery of the construction sector, which was a major contributor to the peak of NPLs reached in the aftermath of the great recession. Finally, some progress was made in the implementation of the reform of the insolvency framework in the second semester of 2021. An efficient insolvency regime is essential to better cope with a potential increase in bankruptcies as it allows viable companies to restructure debt, avoid the accumulation of non-performing debt and support a more efficient reallocation of resources. As part of the Italian RRP, the reform introduced, in November 2021, a new out-of-court settlement procedure (*composizione negoziata*), an enhanced digitalization of insolvency proceedings and a reinforced specialisation of courts.

Conclusion

Italy continues to face vulnerabilities with cross-border relevance, relating to the high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in the financial sector. The public debt-to-GDP ratio started to decline in 2021, albeit from a high level. As a result of the pandemic-induced recession and policy response, Italy's public debt rose from 134% of GDP in 2019 to 155% of GDP in 2020. Along with the economic recovery in 2021, the debt ratio fell to around 151% and is forecast to further decline over the next two years. Low productivity growth remains a key growth impediment, given persistent structural shortcomings. Italian banks are more exposed to their sovereign following the COVID-19 crisis. Banking sector asset quality has considerably improved, but may face challenges as the impact of the pandemic fully unfolds. The unemployment rate continued to fall in 2021, while employment partly recovered the losses incurred in 2020. However, the labour force is still lower than before the pandemic crisis mostly because of the decrease of working age population and joblessness continues to persist, especially among the young. Increasing energy prices associated with Russian military aggression against Ukraine may further aggravate economic vulnerabilities, along with the risk of the disruption of energy goods imports from Russia (see box 2.1).

The measures included in the RRP are expected to address imbalances in Italy. Reforms to improve the business environment and to enhance the efficiency of the public administration, as well as investment, particularly in innovation, digitalisation and transport are expected to spur competitiveness and productivity. The effect of investment and reforms can take time to become visible and crucially depends on implementation. To proceed with the government debt-ratio reduction that started in 2021 and to prepare for rising debt servicing costs along with normalising monetary policy, prudent fiscal policies and growth-enhancing reforms, as well as an efficient use of national and European resources are critical. The measures adopted to further improve tax compliance and tax collection and strengthen spending reviews are expected to lead to a more efficient use of resources. Measures to increase labour market participation tend to go in the right direction. Related challenges, notably the lack of affordable quality childcare and the weak coordination between the social safety systems and other labour market institutions, are not yet effectively addressed. The measures adopted to support the employability of workers and those forthcoming are expected to make the labour market more efficient. The progress made in the implementation of the insolvency reform is expected to support a more efficient allocation of financial resources.

([13]) Among others, the Central Guarantee Fund for SMEs, Sace guarantee and Gasparrini Fund, were the main extraordinary measures introduced to support firms and households after the pandemic.

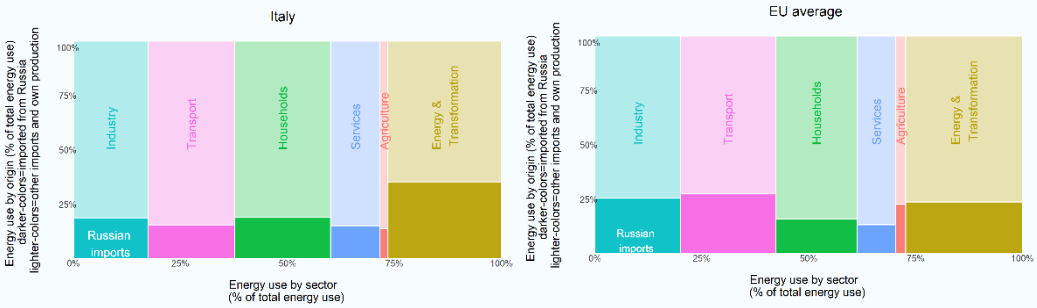
Based on the findings in this in-depth review, the Communication "European Semester – 2022 Spring Package" ([14]) sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Italy, in line with Regulation 1176/2011.

([14]) European Commission (2022), European Semester Spring Package 2022, COM(2022)600 final.

Box 2.1: Exposures to the commodity price surge and to Russia

This box summarises risks and exposures related to the commodity price surge and the direct links with the Russian economy. The surge of commodity prices since the second half of 2021 has been aggravated by the Russian military aggression against Ukraine. This box reviews the risks for Italy's economy. The data presented in this box suggests that surging energy prices are a pressing concern, along with the risk of the disruption of energy goods imports from Russia. The energy price increase has already started affecting the current account balance and will likely negatively affect households' real disposable incomes and companies' expenditures, with uncertain repercussions over the medium term.

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia

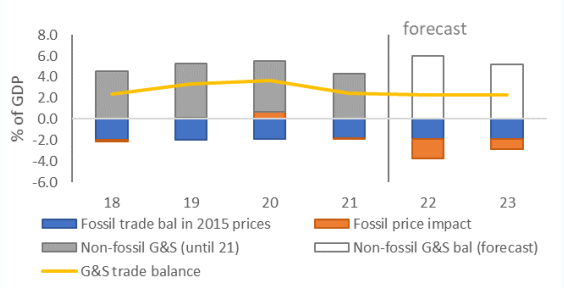


Notes: The left panel displays the distribution of primary energy usage in Italy according to Eurostat energy balances. The horizontal axis displays the relative importance of energy-consuming sectors. The vertical axis displays the importance of energy from Russia in satisfying that need. Note that this dependence on Russia differs according to sector's use of natural gas vs oil and coal. For comparison, the right hand panels displays the same concept for the EU aggregate. Russian imports include oil and petroleum products,natural gas and solid fossil fuels.
Sources: Eurostat and European Commission services calculations

Italy's energy production relies significantly on natural gas and depends considerably on Russia for its energy goods supply. In 2020, Italy's gas imports from Russia amounted to 43% of its total natural gas imports, close to the EU average (Table b.1.1). Electricity production and heating are strongly based on the use of natural gas and firms and households are thus particularly exposed to gas price increases and potential disruptions of Russian energy imports (Graph b.1.1). Therefore, the recent commodity price surge and possible supply disruptions are likely to have a strong and direct impact on the Italian economy.

The commodity price surge has a strong direct impact on the trade balance. Higher commodity prices are expected to lower the trade balance by close to 2 pp. of GDP in 2022 (see Graph b.1.2). Nonetheless, the trade balance is likely to remain in surplus. Overall, the terms-of-trade shock is likely to negatively affect household real disposable incomes.

Graph b.1.2: Italy goods and service trade balance – fossil trade contribution



Notes: The graph displays the trade balance as % of GDP, and highlights net trade of petroleum products, natural gas and solid fossil fuels (mainly coal), in 2015 import prices. The 'fossil price impact' component details the impact of price changes on the (also changing) real trade balance. 2022 and 2023 figures reflect central assumptions of the Commission spring forecast, notably combining the forecasted fossil price evolution with broadly forecasted import quantities of fossil energy sources.

Financial exposures vis-à-vis Russia are concentrated on the banking sector. Italian banks are among those in the EU most exposed with total claims representing about 1.2% of Italian GDP, the bulk of which is accounted for by large banking groups (See Chapter 3). However, the capitalization and Russian asset-to-liability ratios of the latter suggest spillover risks to be limited even in case of a

full asset wipe-out in an extreme scenario. Financial sanctions and related effects can thus be surmised to have a minor potential effect on the Italian banking sector and financial stability.

Table b.1.1: Selected exposures

Trade & financial exposures	unit	IT	EU
Domestic value added embodied in exports to Russia	% of GDP	0.4%	0.4%
Non-energy Russian import content in final demand	% of GDP	0.4%	0.4%
Russian tourist nights spent	% of total 2019	2.6%	2.7%
FDI assets held in Russia	% of 2020 GDP	0.8%	2.5%
Portfolio & other inv. assets held in Russia	% of 2020 GDP	0.4%	0.9%
FDI liabilities towards Russia	% of 2020 GDP	0.0%	1.2%
Portfolio & other inv. liabilities towards Russia	% of 2020 GDP	0.1%	1.1%
Consolidated banking exposures towards Russia	% of 2021 GDP	1.2%	0.5%

Energy mix	unit	IT	EU
Solids fossil fuels (incl. peat)	% of Gross inland consumption 2020	3.7%	10.8%
Oil and petroleum products	% of Gross inland consumption 2020	32.4%	32.7%
Natural gas	% of Gross inland consumption 2020	42.0%	24.4%
Renewables and waste	% of Gross inland consumption 2020	22.0%	19.0%
Nuclear	% of Gross inland consumption 2020	0.0%	13.1%
Commodity exposures	**unit**	**IT**	**EU**
Net petroleum imports from all countries	% of GDP 2021	1.2%	1.2%
Crude oil imports from Russia '20	% of oil imports	11.1%	25.7%
Net gas imports from all countries	% of GDP 2021	0.8%	0.6%
Gas imports from Russia '20	% of gas imports	43.3%	43.6%

Data sources: Eurostat for commodity exposures, European Commission Figaro for value-added exposures, BIS for consolidated banking exposures, European Commission FinFlows for other financial exposures. Energy gross inland consumption excludes net imports of electricity and derived heat.

Table 2.1: **Selected economic and financial indicators (Part 1), Italy**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Real GDP	1.1	-1.4	0.4	0.9	0.5	-9.0	6.6	2.4	1.9
Potential growth (1)	0.8	-0.2	-0.1	0.0	0.0	-0.1	0.2	0.5	1.0
Contribution to GDP growth:									
Domestic demand	1.0	-1.7	0.2	1.1	0.2	-7.9	6.2	2.7	1.8
Inventories	0.1	-0.2	0.2	0.1	-0.4	-0.3	0.2	0.0	0.0
Net exports	0.0	0.6	-0.1	-0.3	0.7	-0.8	0.2	-0.2	0.0
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.3	-0.3	0.1	-0.3	-0.4	-0.3	-0.2	-0.1	0.4
Capital accumulation	0.6	0.3	-0.1	0.0	0.0	-0.1	0.1	0.3	0.3
Total factor productivity	-0.1	-0.1	-0.1	0.3	0.3	0.3	0.3	0.3	0.3
Output gap (2)	1.8	-1.3	-3.2	0.2	0.7	-8.3	-2.4	-0.5	0.3
Unemployment rate	7.6	8.5	12.1	10.6	9.9	9.3	9.5	9.5	8.9
Harmonised index of consumer prices (HICP)	2.3	2.4	0.6	1.2	0.6	-0.1	1.9	5.9	2.3
GDP deflator	2.3	1.5	1.0	1.1	0.9	1.4	0.5	3.1	2.4
External position									
Current account balance (% of GDP), balance of payments	-1.0	-2.2	1.9	2.5	3.2	3.7	2.5	1.2	1.6
Trade balance (% of GDP), balance of payments	-0.1	-0.7	2.9	2.4	3.4	3.7	2.4	.	.
Primary income balance (% of GDP)	0.1	-0.3	0.0	1.1	0.8	1.2	1.2	.	.
Secondary income balance (% of GDP)	-1.0	-1.2	-1.0	-1.0	-1.0	-1.2	-1.1	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	0.0	0.6	1.4	2.1	2.2	2.3	2.1	2.2	2.1
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-0.3	-0.2	-0.3	0.1	0.3	0.4	0.6	0.8	0.9
Capital account balance (% of GDP)	0.1	0.1	0.1	0.0	-0.1	0.0	-0.1	.	.
Net international investment position (% of GDP)	-16.7	-21.0	-16.6	-5.0	-1.1	2.0	7.4	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-9.4	-22.4	-15.9	-6.0	-0.1	1.1	6.7	.	.
Net FDI flows (% of GDP)	0.4	1.0	-0.1	0.0	-1.1	-0.3	0.9	0.1	2.4
Competitiveness									
Unit labour costs (ULC, whole economy)	2.3	2.1	0.5	2.0	1.3	2.1	-0.1	1.8	0.9
Nominal compensation per employee	2.7	1.1	0.5	2.0	1.3	-5.1	6.0	3.6	1.7
Labour productivity (real, hours worked)	0.1	0.0	0.3	0.0	0.5	2.3	-1.3	0.6	0.0
Real effective exchange rate (ULC)	1.4	-0.1	-0.4	1.7	-2.3	.	.	.	.
Real effective exchange rate (HICP)	0.1	-0.8	-0.2	1.9	-2.2	0.9	-0.3	.	.
Export performance vs. advanced countries (% change over 5 years)	-0.8	-12.5	-8.7	-2.4	-3.9	-2.4	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	97.0	121.3	115.9	107.8	106.0	118.7	116.4e	.	.
Household debt, consolidated (% of GDP)	32.8	42.4	41.9	40.8	41.1	45.0	44.7e	.	.
Household debt, fundamental benchmark (% of GDP) (6)	22.4	30.4	36.4	36.8	37.1	41.0	39.0	.	.
Household debt, prudential threshold (% of GDP) (6)	35.1	35.6	37.6	39.9	41.4	43.6	43.8	.	.
Non-financial corporate debt, consolidated (% of GDP)	64.2	78.9	73.9	67.0	64.9	73.7	71.7e	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	47.4	53.2	58.5	57.1	56.8	62.0	58.4	.	.
Corporate debt, prudential threshold (% of GDP) (6)	57.1	59.9	65.0	69.1	72.1	77.3	77.7	.	.
Private credit flow, consolidated (% of GDP)	9.3	2.9	-0.6	2.0	0.3	4.1	3.3e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.1	0.6	2.8	3.2	3.3	6.1	5.2	4.8	5.1
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	0.9	1.8	1.5	1.4	7.2	4.4	1.8	0.7
Net savings rate of households (% of net disposable income)	8.7	4.6	3.1	2.6	2.4	10.2	7.5	.	.

(e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.
(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.
(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42
Source:

Table 2.2: **Selected economic and financial indicators (Part 2), Italy**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Housing market									
House price index, nominal	6.1	0.3	-3.2	-0.6	-0.1	1.9	2.6	.	.
House price index, deflated	3.6	-1.6	-3.7	-1.5	-0.7	2.1	0.9	.	.
Overvaluation gap (%) (7)	8.8	16.5	-2.9	-9.2	-9.9	-7.7	-7.8	.	.
Price-to-income overvaluation gap (%) (8)	5.6	16.3	0.5	-8.4	-9.4	-5.5	-7.0	.	.
Residential investment (% of GDP)	5.4	5.4	4.2	4.1	4.0	4.0	4.9	.	.
Government debt									
General government balance (% of GDP)	-3.1	-3.7	-2.6	-2.2	-1.5	-9.6	-7.2	-5.5	-4.3
General government gross debt (% of GDP)	105.6	117.6	134.4	134.4	134.1	155.3	150.8	147.9	146.8
Banking sector									
Return on equity (%)	9.7	-0.6	-3.0	5.8	4.8	0.8	.	.	.
Common Equity Tier 1 ratio	6.9	8.8	12.1	14.1	15.1	17.2	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances)	4.4	8.3	12.4	6.9	5.4	3.5	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	14.8	8.4	6.7	4.5	4.0	.	.
Cost of borrowing for corporations (%)	4.8	4.0	2.6	1.8	1.7	1.6	1.3	.	.
Cost of borrowing for households for house purchase (%)	4.3	3.8	2.5	1.9	1.4	1.3	1.4	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

3. THEMATIC CHAPTER: FINANCIAL SECTOR

The Italian banking system has reduced vulnerabilities since the global financial crisis. The NPL ratio considerably decreased, although it is higher than the EA average and lengthy insolvency procedures impede a fast resolution of legacy NPLs. The exposure of Italian banks to sovereign risk remains significant and especially smaller and innovative firms lack access to finance, in particular in regions that lag behind.

Asset quality and non-performing loans

Italian banks further reduced their stock of non-performing loans (NPL), with NPL workouts continuing during the pandemic. On the back of the NPL disposals, the gross NPL ratio (gross NPL as percentage of total loans) at system level decreased from the peak of 16.8% in Q3-2015 to 6.7% in Q4 2019. By Q3 2021, the NPL ratio further declined to some 4% ([22]), due to both an increase in total loans (denominator effect) and a reduction in the NPL legacy stock (numerator effect), while the share of NPLs remains significantly higher for non-financial-companies (NFCs) than for households (Graph 3.1 (a)). The disposal of bad loans (*sofferenze*), the worst category of impaired assets, has been the main driver of banks' legacy NPL reduction, with a large part of non-performing private debt transferred to specialised financial institutions. As a result, the segment of unlikely-to-pay (UtP) ([23]) loans represents an increasing share of the remaining NPL stock. ([24]) The coverage ratio at system level remained broadly stable over the last year (52% in Q4-2021). ([25])

The COVID-19 pandemic did not lead to a rise in NPLs so far, notably due to government support measures. Borrower relief measures and liquidity support, in particular loan moratoria, helped shoring up corporate balance sheets. The disposal of NPLs has been supported mainly by NPL securitisations benefitting from government support (GACS scheme), but also by the provisions of the "Cura Italia" Decree of March 2020, allowing banks to convert deferred tax assets into tax credits against NPL sales. Moreover, the prudential guidance of supervisory authorities on the flexibility concerning the classification of loans, which aimed to reduce the potentially pro-cyclical effects of an increase in credit risk, and the regulatory relief provided through the Capital Requirement Regulation II (CRR II) ([26]) amendments also helped.

The Italian government prolonged the loan moratoria for the last time until December 2021. This third prolongation affected only the capital component of the instalments, while borrowers had to pay interest rate expenses. By 31 December 2021, 83% of approved moratoria had expired. The total volume of loans with non-expired moratoria (i.e. legislative and voluntary moratoria granted by banks) amounted to EUR 44 billion, of which EUR 36 billion concerned loans to non-financial corporations. ([27]) The ability of these debtors to return to regular debt servicing will be tested in 2022, with potential repercussions on asset quality and NPL accumulation. The increase in Stage 2 loans (i.e. loans that show a significant increase in credit risk according to IFRS 9) as a share of total performing loans from 12.9%

([22]) Controlling for loans growth the ratio would be 4.83% in Q3 2021 (gross $NPL_{Q3\text{-}2021}$/Loans $_{Q4\text{-}2019}$). The level of gross non-performing debt was EUR 138.5 bn in Q3 2019 and decreased to EUR 91 bn in Q3 2021. (Numerator effect). In the same period, the level of total loans increased from EUR 1971 bn to EUR 2314 bn. (Denominator effect).

([23]) While loans are classified as 'bad loans' based on the criteria related to past-due payments, the classification as 'unlikely-to-pay' relies less on the quantitative criteria and defines some events that trigger the non-performing classification.

([24]) Some second-tier banks have NPL ratios above the system level, though they represent a smaller part of the overall NPL stock.

([25]) Bank of Italy: Financial Stability Report (April 2022).

([26]) The CRR "quick fix" modified the IFRS 9 transitional arrangements to mitigate the impact on regulatory capital and on banks' lending capacity of the likely increases in expected credit loss ("ECL") provisioning under IFRS 9 due to the economic consequences of the COVID-19 crisis. The CRR quick fix amended Article 473a CRR, which contains arrangements allowing institutions to add back to their Common Equity Tier 1 ("CET1") capital a portion of any increase in provisions due to the introduction of ECL accounting under IFRS 9 during a transitional period. The CRR "quick fix" also introduced a new transition period that allows financial institutions to add-back increases in ECL provisions for non-credit-impaired assets to CT1 capital during 2020-2024.

([27]) Bank of Italy, COVID 19 Task force: Press release, January 13, 2022.

in June 2020 to 14.6% at the end of 2021 indicates that the close monitoring of these exposures remains warranted (see footnote 14).

Liquidity, capital, and profitability

Liquidity conditions of Italian banks remained stable. Short-term liquidity of Italian banks, as measured by the Liquidity Coverage Ratio (LCR) at system level, stood at 203,2% in February 2022, far above the required level of 100%. The Net Stable Funding Ratio (NSFR) for Italian banks equalled 134.5% as of Q4 2021, while none of the Italian institutions posted a ratio below the mandatory threshold of 100%. ([28]) The comfortable liquidity position is, inter alia, attributable to the Eurosystem refinancing operations providing abundant liquidity and to the increase in deposits, both by companies and households.

The capitalisation of Italian banks is markedly higher than it was prior to the double-dip recession between 2008 and 2013. Lower loan-loss provisions amid a more favourable macroeconomic environment had a positive impact on capitalisation, while the resumption of dividend payments contributed somewhat negatively to the banks' capital base. The Common Tier 1 (CET1) ratio at system level stood at 15.1% in Q3-2021, implying a drop of 40 basis points compared to Q4-2020. This decrease is mainly attributable to the phasing-out of the transitional prudential arrangements connected with the adoption of IFRS 9.

Banks' profitability underpinned by sound asset quality would be a key element for strengthening the capital base. In the first half of 2021, the profitability of Italian banks rose considerably compared to the end of 2020, contributing to an organic build-up of capital. As such, the Return on Equity (ROE) at system level rose from 1% to 5.8% in Q3-2021. The increase is mainly attributable to the drop in loan-loss provisions, compared to a very high level 2020, and to a rise in banks' net fees.

Insolvency

Insolvency proceedings in Italy remain lengthy compared to other EU economies, but the full implementation of the 2019 insolvency code is currently underway. The pandemic delayed the entry into force of the reform of the insolvency framework to 2022 and alternative in-court and out-of-court arrangements introduced over the last years had a limited impact so far. A new out-of-court settlement procedure (*composizione negoziata per la soluzione della crisi di impresa*) adopted in August 2021 is expected to help restructure companies that are under distress at an earlier stage, thus reducing the workload of courts and enhancing the efficiency of the judicial system. In 2022, Italy is expected to transpose the EU Directive ([29]) and to adopt the delegated acts on insolvency. The full implementation of the 2019 insolvency code coupled with efficiency gains in the court system, as part of Italy's RRP, could be beneficial both for addressing a potential increase in bankruptcies and for averting the new accumulation of non performing debt, as the effect of the pandemic on NPL could become visible with a certain time lag.

Sovereign-bank nexus

Italian banks' exposure to sovereign risk remains significant. Domestic exposure ([30]) as a share of banks' total assets increased slightly from 20.8% in December 2019 to 21.3% in December 2021, significantly above the Euro area average (Graph 3.1 (e) and (f)). More specifically, debt securities held by the Italian banking system amounted to EUR 410 billion in December 2021, accounting for 13% of total banking assets. This segment of domestic exposure constitutes a potential short-term vulnerability as domestic sovereign bond volatility could negatively affect banks' capital base. Italian sovereign bond yields had fallen to 0.3% by summer 2021, largely due to the ECB's asset purchasing programmes, but rose to 2.86% by end of April 2022. ([31]) The ECB's Governing Council decided to discontinue net asset

([28]) As of June 2021, the Net Stable Funding Ratio (NSFR) became a mandatory requirement. The source for NSFR data is the statistical annex of the Financial Stability Report (April 2022) of Bank of Italy.
([29]) The Council of Ministers approved – in preliminary examination - the related changes in March.
([30]) ECB BSI Data: Domestic exposure is calculated as the loans to the Government and the government securities held by the banking system.
([31]) Bloomberg, 10-years Italian sovereign bond, "BTP decennale".

purchases under the Pandemic Emergency Purchase Programme (PEPP) at the end of March 2022 and recent bond market volatility has underscored the uncertainties surrounding the outlook.

Due to some mitigating factors, short-term risks stemming from home bias are still lower than during previous periods of market turmoil. The temporary prudential filter for unrealised gains and losses on banks' holdings of public debt measures at fair value, implemented under the Capital Requirement Regulation (CRR) "quick fix" and in force until 31 December 2022, decreases the impact of increasing sovereign yields on banks' core equity. In addition, Italian banks continued to rebalance their sovereign exposures in favour of the amortised cost portfolio, ([32]) thereby increasingly shielding their capital base from sovereign bond volatility. A recent simulation by the Bank of Italy shows that an upward shift of 100 basis points in the entire sovereign yield curve would lower the common equity tier 1 ratio (CET1 ratio) on average by 21 basis points. ([33]) In comparison, a similar exercise performed in 2019 led to a decline of 40 basis points on average in banks' CET1 ratio.

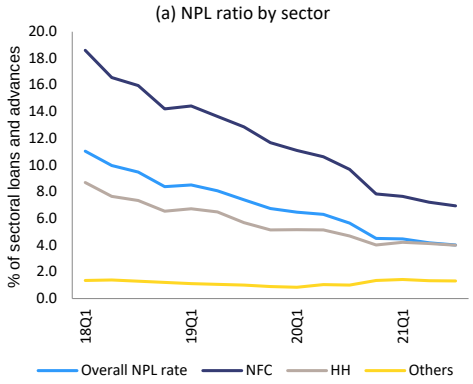
However, the level of public guarantees in banks' portfolios significantly amplified the sovereign-bank nexus. In Q4-2021, bank loans guaranteed by both the SME Guarantee Fund and SACE as a share of total loans to non-financial corporations stood at 41%, ([34]) corresponding to 6.9% of total banking assets. The SME Guarantee Fund issued the largest share of guarantees, covering a credit volume of about EUR 272billion ([35]) as of 31 December 2021, compared to a pre-pandemic level of 13.3 billion in December 2019. Finally, loans to corporates and SMEs granted by SACE, the Italian export credit agency, reached almost EUR 32.6 billion in February 2022. ([36]) Government provisions however, seem sufficient to cover potential losses on the stock of guaranteed loans.

Access to bank and non-bank finance

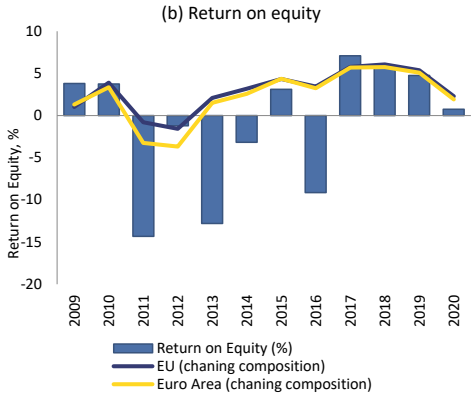
Italy's financial system remains predominately bank-based with limited access for firms to non-bank finance. In 2020, venture capital investment as a share of GDP stood at 0.02%, ([37]) with Italy ranking below the EU average and peer countries. An increase in the volume of market finance, including equity, would allow firms to diversify their funding sources, make Italian firms less vulnerable to potential shocks in the banking sector and allow for wider risk sharing. Among the initiatives to promote non-bank finance, the allowance for corporate equity (ACE), abolished in 2019, was reintroduced in 2020 and further reinforced in 2021. ([38]) In 2019, the government launched the National Fund for Innovation (*Fondo Nazionale Innovazione*) to promote venture capital. The Decree Law 121/2021 ("*Decreto Infrastrutture*") increased the capital endowment of the fund with a budget of up to EUR 2 billion. In addition, the Recovery and Resilience Plan will allocate a further EUR 300 million for start-up financing and EUR 250 million to develop the venture capital market in the field of green transition. However, major policy interventions are limited to start-ups and early-stage investment, while promoting private equity financing could be beneficial both for the growth phase of young firms and the restructuring of established firms. Furthermore, targeted training for firms on the use of the different non-bank financing facilities (financial literacy) could help increase the diversification of financing sources.

([32]) Bonds placed into the amortised cost portfolio are not valued with market prices and therefore shielded from market volatility.
([33]) Further breakdown reveals 18 basis points for significant banks and 37 basis points for less significant banks. See Bank of Italy Financial Stability Reports 2021 No. 2 and 2019 No. 2.
([34]) These numbers considered only the loan share covered by the public guarantees.
([35]) MISE: SME Guarantee Fund Data: These estimates refers to the amount guaranteed as December 2021. Total value of bank loans under public guarantee for this measure: EUR 218 bn as of 31 December 2021.
([36]) MEF Press release of the 13/01/2022 and 23/02/2022. These estimates are preliminary, as the measure have been extended until June 2022.
([37]) Source: OECD, Enterprise Statistics, Venture Capital investment. (2020)
([38]) The Decree Law 73/2021 ("Decreto Sostegni bis") introduced the "Super ACE", substantially increasing the percentage used to calculate the fiscal deduction (15% from 1.3% previously, with a cap of EUR 5 million) and providing for the possibility to turn the deduction into a tax credit.

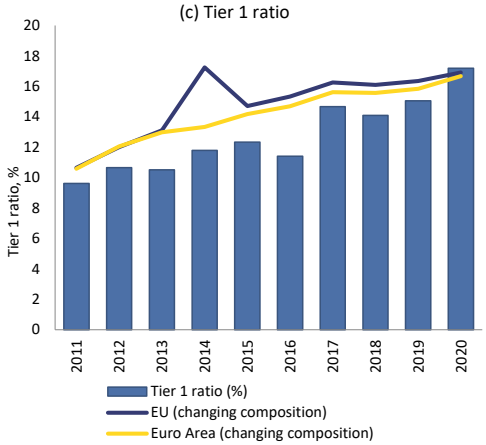
Graph 3.1: **Thematic Graphs: Financial sector**



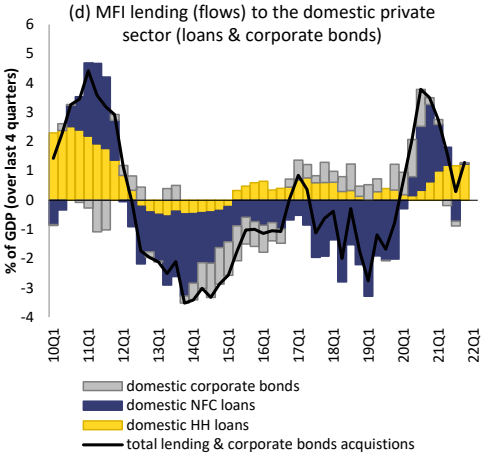
Source: EC baced on ECB data, consolidated banking data, domestic banking groups and stand alone banks.



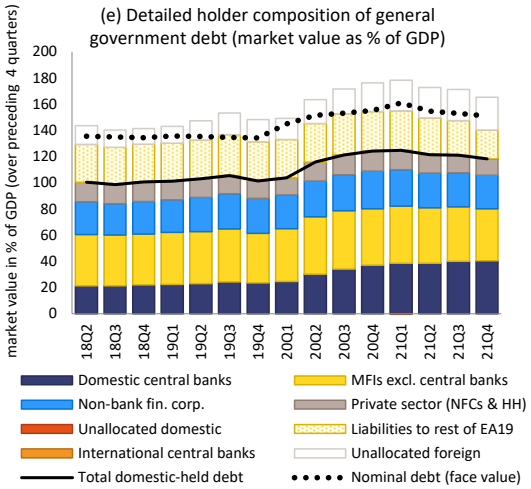
Source: based on ECB CBD2, consolidated banking data, all domestic banking groups and stand alone banks.



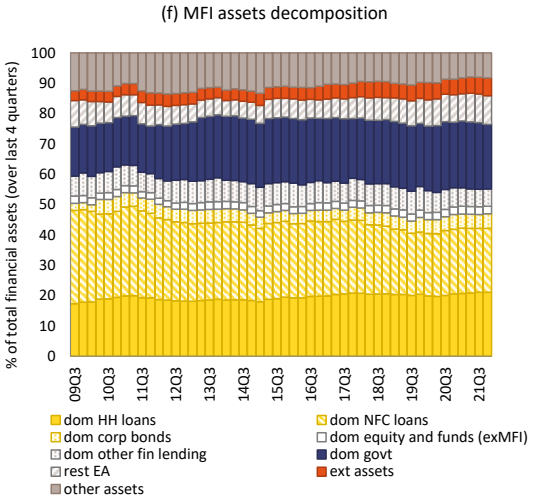
Source: ECB bank lending survey



Source: based on ECB BSI



Source: Commission services based on ECB, Eurostat and IMF



Source: BSI ECB data

Source: European Commission services