MEF Dipartimento del Tesoro

Relevant Factors Influencing Public Debt Developments in Italy

November 2018

Ministero dell'Economia e delle Finanze

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EXECUTIVE SUMMARY

- Italy's public finances continued to improve in the first semester, and the general government deficit is projected to decline to 1.8 percent of GDP this year, from 2.4 percent in 2017 (2.0 percent excluding banking sector support measures).
- The general government debt-to-GDP ratio in 2017 declined for the third consecutive year, to 131.2 percent, from a peak of 131.8 percent in 2014. Excluding the one-off banking sector interventions, it would have registered a 130.2 percent level. The debt ratio is projected to further decline to 130.9 percent this year.
- Italy's solid budgetary performance rests on a consistent track record of primary surpluses: the updated estimate for this year is 1.8 percent of GDP (2.8 percent on a cyclically-adjusted basis). If Italy enjoyed a real cost of public debt financing comparable to the 'core' Euro area member states, this primary surplus level would more than suffice to produce substantial annual declines in the debt-to-GDP ratio.
- However, owing to still-large intra-Euro area bond yield and growth differentials, Italy in 2017 did not fulfill the debt criterion 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 European Commission is expected to prepare a report identifying "all other relevant factors" that should be considered when assessing compliance with the Debt rule.
- In its latest 126(3) Report, issued on 23 May 2018, the Commission concluded that, with respect to 2017, "the debt criterion as defined by the Treaty and Regulation (EC) 1467/1997 should be considered as complied with." However, following Italy's submission of its Draft Budgetary Plan (DBP) 2019 on 16 October 2018, the Commission decided to revisit the question of 2017 compliance with the Debt rule on grounds that the DBP 2019 does not comply with the Country-Specific Recommendations (CSRs) addressed to Italy by the Council on 13 July 2018.
- At the request of the Commission, the Italian government is also submitting a revised version of the DBP 2019. In addition, this report illustrates a series of factors Italy believes to be "relevant in order to comprehensively assess in qualitative terms the excess (of the debt ratio) over the reference value."
- The first relevant factor discussed in this report is cyclical developments. Since the beginning of the year the Euro area has recorded a slowdown in exports and industrial production. Italy's export-oriented manufacturing industry has been significantly affected by the downturn in world trade and by the protectionist measures and sanctions announced by the US and other countries.
- This slowdown comes on the heels of years of economic under-performance, during which restrictive fiscal policies improved the numerator of the deficit and the debt ratio but did not totally succeed at revitalising the denominator, that is, nominal GDP. The Italian government judges that further fiscal tightening — worth 0.6 percentage points of GDP in structural terms if Italy were to strictly comply with the fiscal CSR — would risk aggravating the slowdown that is under way.

- A second and related factor is the degree of slack in the Italian economy. In recent years, Italy regained wage and price competitiveness vis-à-vis the European average and its main trading partner, Germany. According to Eurostat, in 2017 Italy's average hourly labor 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 by-product of continuing slack in the labor market and in the economy at large. Italy's unemployment rate, at 10.1 percent as of September, is three times higher than Germany's (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 2017 Autumn Forecast, Italy's 2017 gap 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, according to the Commission's latest forecast (Autumn 2018), the output gap, after registering a -0.3 percent reading this year, would turn positive in 2019 (+0.3) and then rise to +0.8 percent in 2020 even though unemployment remains high and the lack of inflationary pressures still points to ample slack in the economy.
- In Chapter 3 of the present report, we update the analysis presented in the previous edition (May 2018) and once again 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 the Commission's estimates and would still be -3.2 percent this year.
- With these, more realistic output gap estimates, Italy's structural budget balance would have been -0.4 percent of GDP in 2017 and -0.2 percent this year. Regardless of flexibility margins granted by the Commission, Italy would have broadly achieved its Medium Term Objective (of a balanced structural budget) this year.
- The importance of output gap estimates in European fiscal rules is such that, using the alternative output gap estimates and assuming a growth rate of 2 percent in the GDP deflator, in 2017 Italy would have satisfied the debt rule in the cyclically-adjusted configuration, outperforming the benchmark by 1.2 percentage points. Excluding the one-off intervention in the banking system, the distance from the benchmark would have been an even more compelling 2.2 percent of GDP.
- The third relevant factor is that the key goals of the moderate fiscal expansion envisaged in the DBP 2019 are to substantially improve social inclusion and to revitalize public investment.
- The Joint Employment Report (JER) 2018, the Country Report Italy 2018 and the CSRs 2018, all urged Italy to improve social inclusion, in particular by promoting an increase in the employment rate via a reform of Active labor market policies (ALMPs), raising labor market participation of women and rationalizing family-support measures.
- The Citizenship Income policy featured in the DBP 2019 responds to these recommendations, as it involves a significant increase in income support for individuals and households below the poverty line and in addition earmarks substantial human, financial and technological resources for Job Centers and other ALMPs.

- In addition, the DBP raises public investment by 0.2 percentage points of GDP in 2019 and 0.3 points in 2020 and 2021 compared to the baseline fiscal scenario. The fourth CSR 2018 urges Italy to foster research, innovation, digital skills and infrastructure through better targeted investment and increased participation in vocational-oriented tertiary education. The plan presented by the Italian government covers all these areas and in addition places great emphasis on revitalizing public works at a time when the collapse of a viaduct in Genoa and huge damages caused by unusually severe storms point to an urgent need for environmental-protection investment and for maintenance of Italy's infrastructure.
- The fourth relevant factor discussed in this report is reforms: the program of the new government consists not only of fiscal measures, but also of reforms in areas ranging from the judicial system to the public sector, from tax enforcement to the prevention of corruption. These reforms, which are illustrated in Chapter 4 of this Report, will raise the growth potential of the economy and its attractiveness for investors.
- The fifth factor is debt sustainability. Moreover, the government believes that the policy course it charted in the DBP 2019 is sustainable, as it will enhance the supply side of the economy (via increased public investment and labor-market participation, as well as greater incentives to private investment and hiring) and support aggregate demand, thereby leading to faster real GDP growth. The scenario analysis presented in this report shows that even if growth fell short of the official targets, the debt-to-GDP ratio would not rise under most conceivable scenarios.
- Considering the debt-sustainability indicators regularly monitored by the Commission, Chapter 6 highlights that with alternative potential growth estimates and with a fifteen-year horizon for the computations, Italy's S1 indicator signals at most a medium 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.
- A sixth factor to consider is the affordability of public debt: interest payments in 2017 fell to 3.8 percent of GDP, and should reach 3.6 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 7.9 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, the contingent liabilities of Italy's general government remain low on a comparative basis.
- Finally, risks for the public finances are limited, and Italy's financial position is strong. The recent rise in government bond yields looks manageable thanks to Italy's long-dated and fixed-rate debt composition. In addition, 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 continue to decline. Banking sector profitability has been restored and systemically-relevant institutions comfortably passed the recent EBA stress tests. The surplus on the current account of the balance of payments is close to 3 percent of GDP, and Italy's net international investment position is close to balance.

I. RECENT BUDGET AND DEBT PERFORMANCE

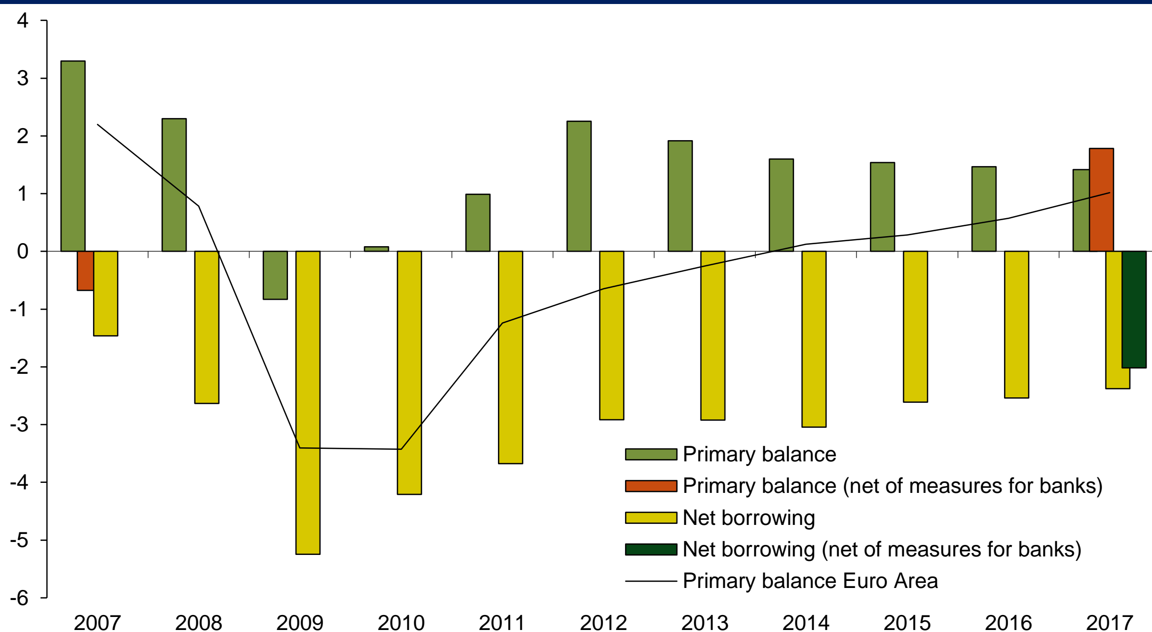
I.1 RECENT BUDGET AND DEBT PERFORMANCE

After posting an outturn of 2.5 percent in 2016, the general government budget deficit declined to 2.4 percent of GDP in 2017, according to the latest ISTAT data (October 2018). Improving economic growth and government deficit-reducing measures worth about 0.1 percentage points of GDP, including effective control of public spending, ensured a further decline in the general government deficit, which has shown consecutive reductions since 2014 while remaining below 3 percent of GDP.

In 2017, the improvement in the budget balance compared to 2016 would have been worth 0.4 percentage points of GDP excluding the budgetary impact of measures taken in support of the banking system[1]. Net of this impact, the general government deficit in 2017 would have dropped to 2.0 percent of GDP.

The primary surplus in 2017 remained stable at 1.4 percent of GDP (1.8 percent of GDP excluding the one-off banking sector support measures), vis-à-vis an average primary balance of around 1.0 percent in the Euro Area.

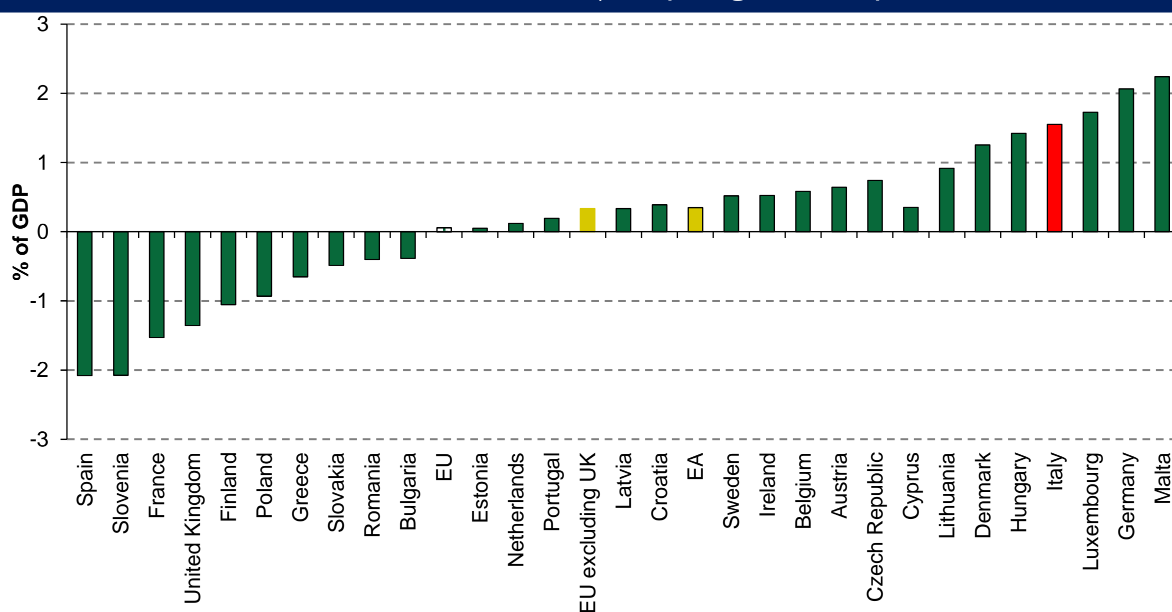
FIGURE I.1 – GENERAL GOVERNMENT DEFICIT AND PRIMARY BALANCE, EDP (% of GDP)



Source: ISTAT and EUROSTAT database.

[1] The imputed losses from the banking sector support measures consist of the net value of the residual nonperforming loan portfolio of the two Veneto Banks (about €4.7 bn) and the drop in the share price of Monte dei Paschi di Siena compared to the recapitalization price (€1.6 bn).

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



Source: AMECO database.

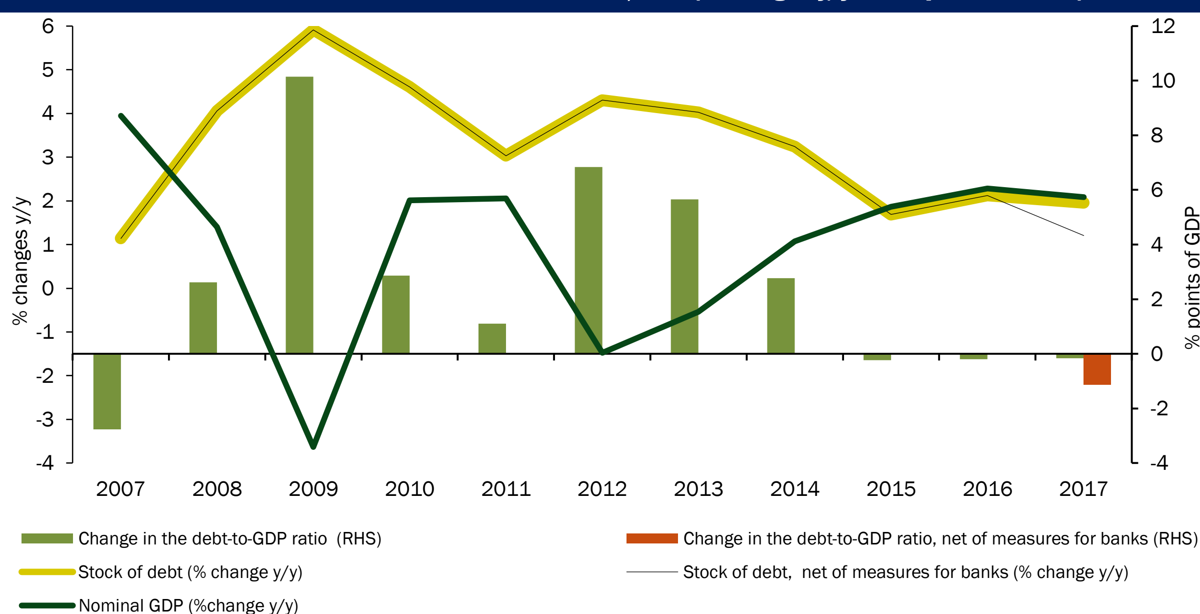
Since the economic and financial crisis, fiscal consolidation has been a central feature of Italy's economic policy and the decline in net borrowing has been ensured by the maintenance of positive primary balances: Italy records one of the highest primary surplus in the Euro Area and the European Union on average over the last five years (about 1.6 percent 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 less than 0.4 percent of GDP.

The 2018 Commission Autumn Forecast projects the Italian primary surplus to improve to 1.7 percent of GDP in 2018 and reduce to 1.0 percent in the following year. Nonetheless, the forecasts confirm the soundness of Italy's position vis-à-vis other European partners with a similar level of debt-to-GDP ratio and economic growth perspectives. The primary balance in the Euro Area is forecast below 1.2 percent in 2018 and 2019. In 2020 Italy's primary surplus is projected to further decline to 0.8 percent of GDP as the no-policy change assumption underlying the Commission forecast does not consider the deficit-reducing effects of the 2020 VAT hike envisaged by the 2019 Budget.

The attainment of a large primary surplus has contributed to the stabilisation of the debt-to-GDP ratio in the last four years. The ratio of public debt to GDP declined to 131.2 percent in 2017. Net of the whole impact of interventions on banks of about 1 percentage point of GDP, the ratio-to-GDP would have declined by about 1.1 percentage points in 2017 (see Fig. I.3). The debt ratio is projected to further decline to 130.9 percent this year.

Underlying the maintenance of high primary surplus in 2017 there is a progressive improvement in the quality of the public finances, while further reinforcement is expected in the following years. In 2017, primary spending as a share of GDP declined by about 0.2 percentage points, ensuring a diminishing tax burden (from 42.4 to 42.2 percent) and primary expenditure-to-GDP ratio (from 45.1 to 44.9 percent).

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



Source: ISTAT.

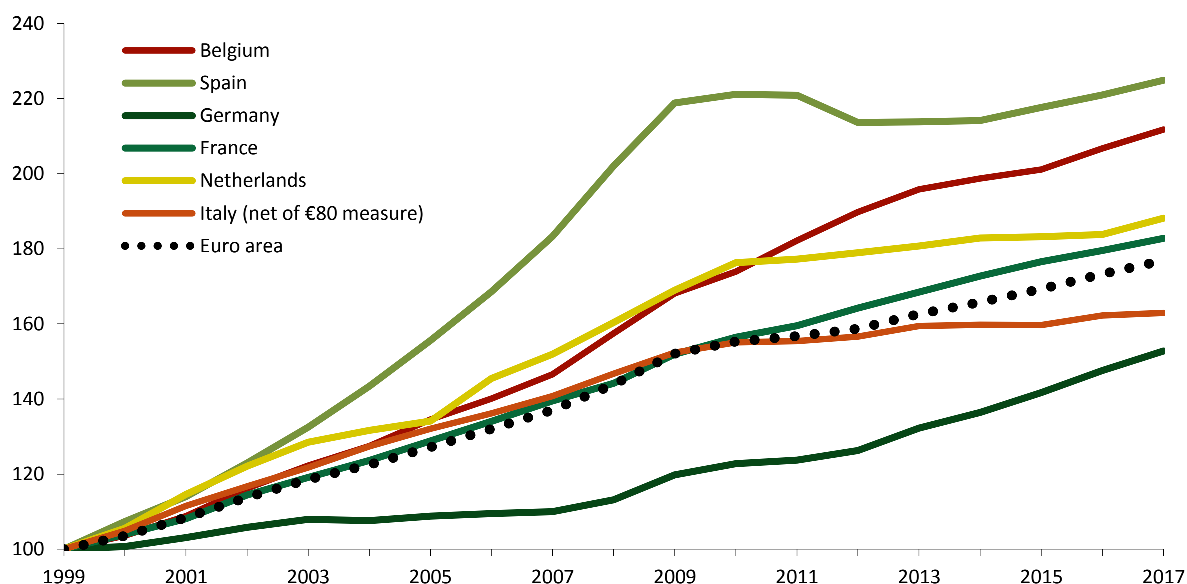
Concerning the year 2018 the primary surplus is expected to reach 1.8 percent of GDP, improving from 1.4 percent in 2017. The tax burden is set to decrease to 41.9 percent, and the ratio of primary expenditure to GDP is estimated to reach 44.3.

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 Report 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 41.7 percent of GDP in 2016 to 41.1 percent in 2017 and is forecast to reduce to a level below 41 percent of GDP in 2019, according to Italy's latest trend projections. The stabilisation of Italy's primary current spending would be even more pronounced if the €80 fiscal measure, which was introduced in 2014 and made permanent in 2015, was classified as a tax break rather than a social transfer in cash.

Growth in Italy's public sector compensation has been extremely muted, compared to both past trends and other Euro area countries, as a result of extreme wage moderation and a decline in payrolls. Compensation rose this year, as a new wage contract for 2015-2018 was signed and payments in arrears were made to employees. Even so, with payrolls still declining, the ratio of compensation to GDP is set to resume falling in 2019 and, on a comparative basis, is only higher than Germany's.

FIGURE I.4 - GENERAL GOVERNMENT PRIMARY CURRENT SPENDING (level, 1999= 100)



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

TABLE I.1 COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (euro bn)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
France	263.6	268.5	273.1	278.5	281.3	283.9	290.1	294.8	299.8
Germany	208.6	212.3	217.8	224.4	229.8	237.8	246.7	254.9	264.1
Italy	169.6	166.1	164.8	163.5	162.1	164.0	164.2	170.1	170.2
Spain	122.6	113.9	114.7	115.2	119.4	121.5	123.0	127.0	131.4

Source: AMECO.

TABLE I.2 COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (% GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
France	12.8	12.9	12.9	13.0	12.8	12.7	12.7	12.5	12.4
Germany	7.7	7.7	7.7	7.6	7.5	7.5	7.5	7.5	7.5
Italy	10.4	10.3	10.3	10.1	9.8	9.7	9.5	9.6	9.4
Spain	11.5	11.0	11.2	11.1	11.0	10.9	10.5	10.5	10.4
EU28	10.6	10.5	10.5	10.4	10.2	10.2	10.1	10.0	10.0

Source: AMECO.

The increase in intermediate consumption in 2017 was 2.9 percent, while social transfers in cash increased at a lower rate of GDP of 1.5 percent. As a result, the 0.4 percent increase in current primary spending was lower rate than GDP 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 and a similar outcome is also expected for the current year; in fact preliminary estimates point to a 2.2 percent contraction. The new policy scenario aims to increase public investment in order to bring capital accumulation back towards pre-crisis levels.

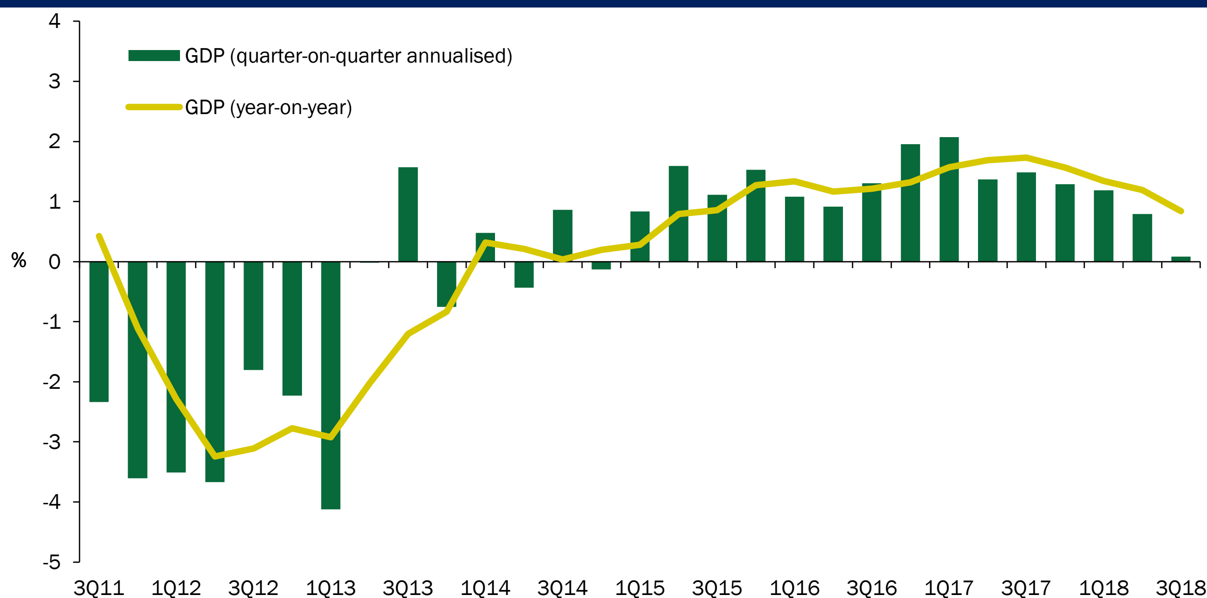
II. MACROECONOMIC CONTEXT

II.1 CYCLICAL DEVELOPMENTS

Economic activity in Italy decelerated in the first half of 2018, as real GDP growth gradually slowed from 0.3 percent q-o-q in 1Q18 to 0.2 percent q-o-q in 2Q2018. According to Istat's flash estimate, real GDP in Q3 was flat over the previous quarter. Protectionist measures and a downturn in key industries such as car manufacturing have weighed on Italian exports.

US trade policy, geopolitical risks and the easing in global growth momentum remain the main downside risks for the Italian economy. In addition, the recent shift in consumer preferences towards hybrid and electric vehicles hit the Italian industry, which is more specialised in gasoline and diesel engines.

FIGURE II.1 – ITALY'S REAL GDP GROWTH

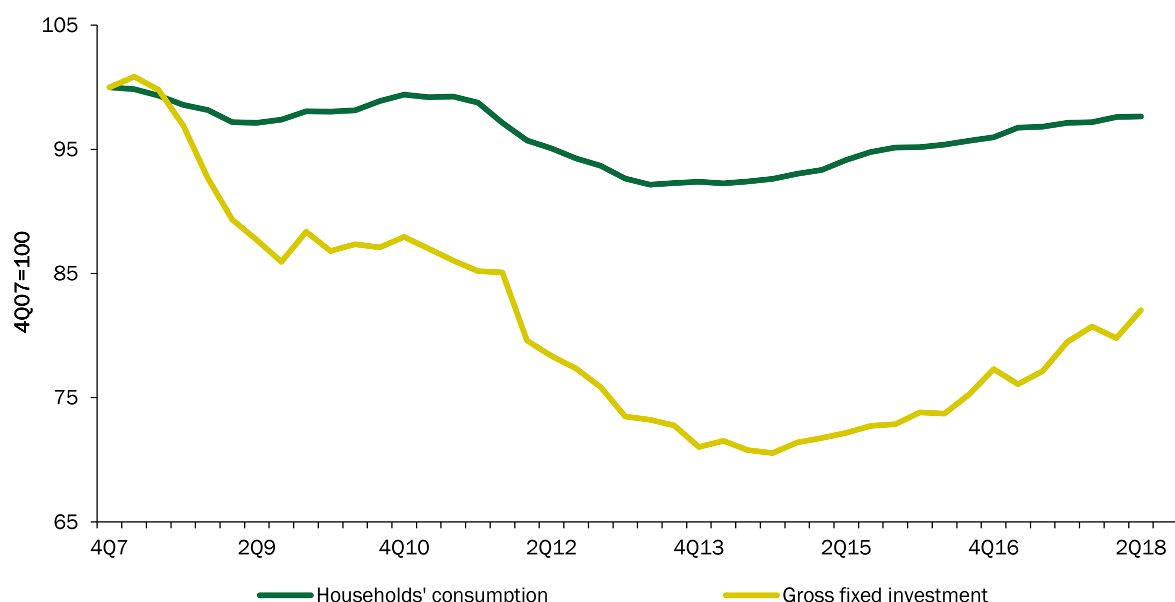


Source: ISTAT.

The latest cyclical indicators point to weakness ahead, stemming mainly from sluggish external demand. The composite PMI declined to 49.3 in October, from a high of 59.0 in January. In line with the PMI, the confidence surveys for businesses (IESI) highlighted the risks of further deterioration in both industry and services, albeit to a lesser extent than the PMI.

Domestic demand (investments and households' consumption expenditure) is still below the pre-crisis level.

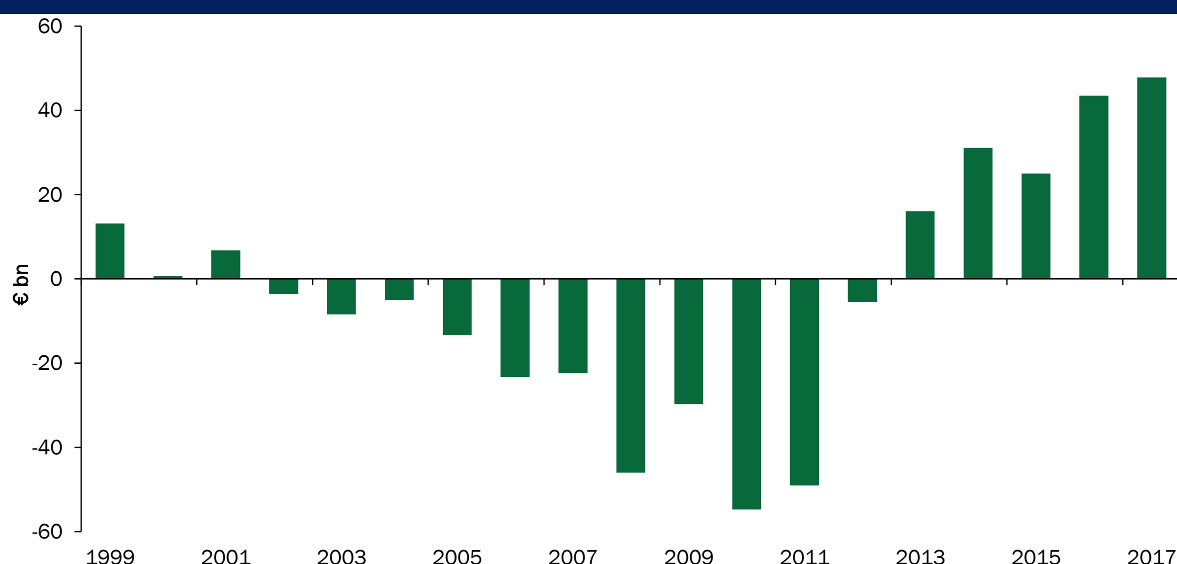
FIGURE II.2 – HOUSEHOLDS CONSUMPTION AND GROSS FIXED INVESTMENT (4Q07=100)



Source: ISTAT.

As noted in previuos reports, Italy benefits from a solid external position with consistent current account surpluses and a near balanced international investment position. In 2017 growth was led by exports accompanied by wage moderation, improving competitiveness and a widening current account surplus (2.8 percent of GDP, from 2.6 percent in 2016). The positive trend in the external accounts has continued in 2018: in the twelve months ending in August the current account surplus amounted to 48.3 billion (2.8 percent of GDP), from 45.7 billion in the corresponding period of 2017. The increase was due to the improvement of the balances in services and primary and secondary income, partly offset by a slight reduction in goods surplus (53.7 billion, from 54.5).

FIGURE II.3 – CURRENT ACCOUNT IN % OF GDP



Source: Bank of Italy.

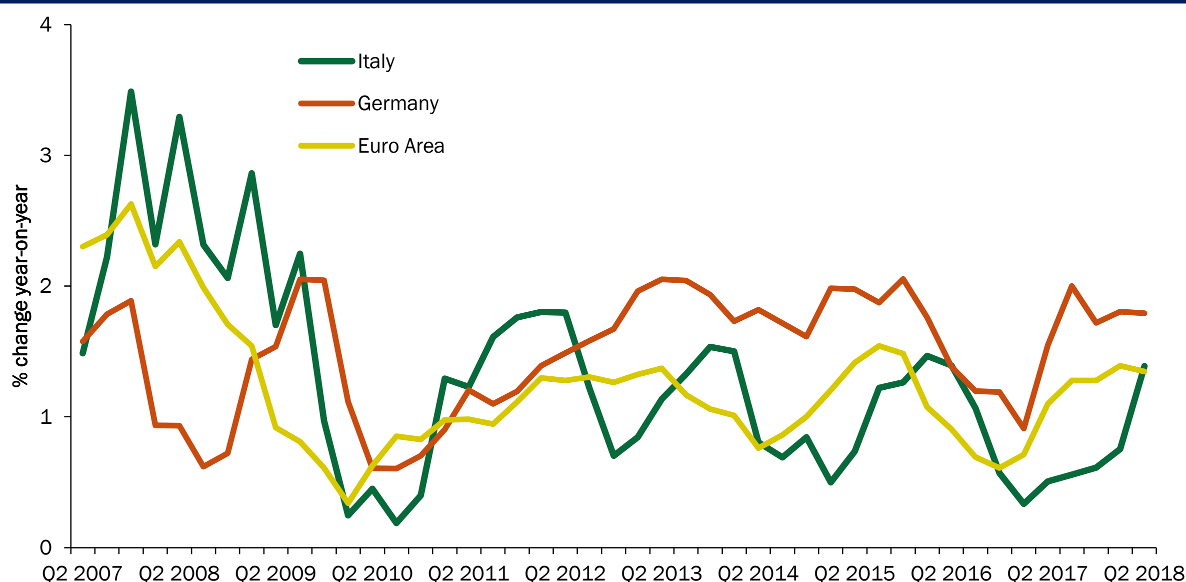
According to the most recent data released by the Bank of Italy, at the end of the second quarter of 2018 Italy's net international investment position stood at -3.4 percent of GDP, declining by some 65 billion (almost four percentage points of GDP) compared to the end of the first quarter. The improvement was due to the current account surplus and to valuation adjustments: following the rise in yields, the value of portfolio liabilities, especially government securities, decreased by about 55 billion.

The improvement in Italy's external position is mainly linked to a persisting slack in the economy as Italy continues to experience low inflation compared to its main European partners. In turn, this entails low nominal GDP growth, which slows down the decline in the public debt-to-GDP ratio.

Growth in the GDP deflator in 2017 slowed to 0.5 percent, from 0.8 percent in the previous year. In 2018 GDP deflator is expected to recover, underpinned by a pickup already registered in 2Q 2018 due to the payment of wage contract renewals and arrears for the public sector. Consequently, in 2018 nominal GDP is projected to increase by 2.5 percent, up from 2.1 percent in 2017.

Nonethless, the GDP deflator is still subdued: in 1H 2018, on average, the gap was 0.3 percentage points vis-à-vis the Euro area and 0.7 points versus Germany.

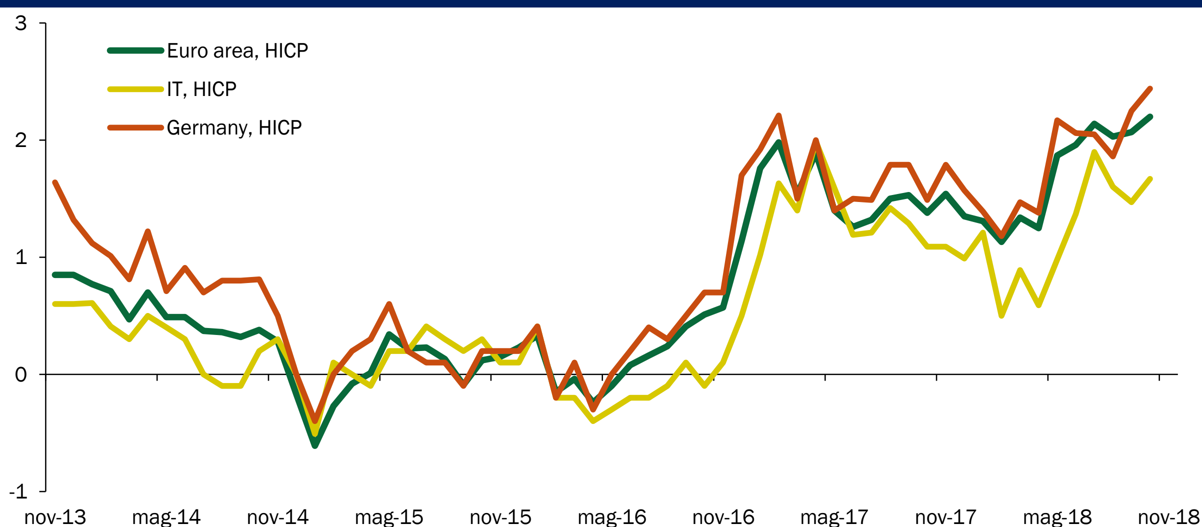
FIGURE II.4 – GDP DEFLATOR GROWTH, % CHANGE Y-O-Y



Source: Datastream.

Harmonised inflation in the first 10 months of the 2018 in Italy remained lower than in Europe. The October 2018 readings were 1.7 percent for the headline index (flash estimate) and 0.9 percent for the core index, versus 2.2 percent and 1.3 percent, respectively, in the Euro area.

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



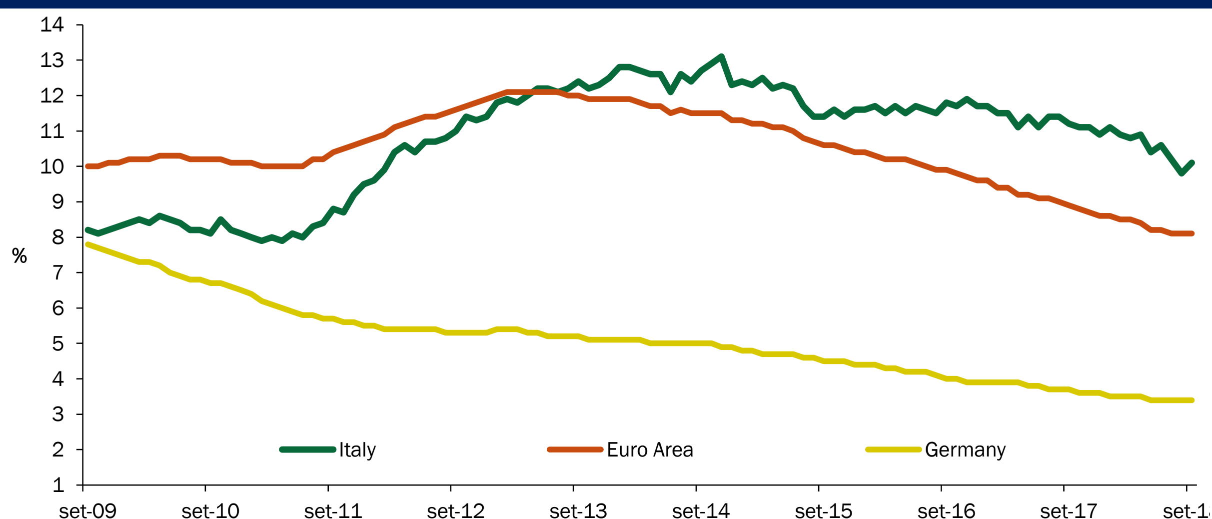
Source: EUROSTAT.

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 September 2018) show an unemployment rate of 10.1 percent in Italy and 8.1 percent in the Euro area. Germany’s unemployment rate has hit a new low of 3.4 percent.

In the first three quarters of 2018, employment grew by 1.1 percent on the same period of the preceding year and the unemployment rate fell by roughly 1 percentage point, to 10.1 percent.

Labour market conditions have improved sharply since 2014, but even so the excess supply of labour continues to bear down on wages. Furthermore increased reliance on fixed term contracts contributed to hold down wage growth especially in the private sector. On the contrary, in the public sector, after ten years of wage stability, contractual wages rose markedly in 2Q18, due to the implementation of a new contract and arrears payments.

FIGURE II.6 – UNEMPLOYMENT RATES (as a percent of labour force)



Source: EUROSTAT.

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

III.1 ALTERNATIVE OUTPUT GAPS AND POTENTIAL OUTPUT ESTIMATES

The assessment of compliance with budgetary rules underpinning the Stability and Growth Pact hinges on output gap and potential output estimates. The EU commonly agreed methodology to estimate such variables is based on a Cobb-Douglas production function. In its current form, the methodology suffers from drawbacks that may lead to implausible output gap estimates.

To begin with, Italy's view is that the estimation of the Non Accelerating Wage Rate of Unemployment (NAWRU) yields pro-cyclical estimates at the end of the forecast horizon that are not optimal from a statistical point of view[2]. As far as Total Factor Productivity (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 for a very long time (from 2005 to 2018, according to the recent Autumn Forecasts).

The double-dip recession of 2008-2013 has aggravated the problem. The ensuing protracted fall in potential output has led to output gaps estimates closing very quickly from 2015 onward and reaching positive territory already next year in spite of a still-high degree of slack in the economy. Wage growth in the private sector remains extremely muted without a feedback into the NAWRU estimates.

Italy has repeatedly raised concerns about the lack of economic intuition of output gap estimates based on the commonly-agreed methodology. The problem has been addressed but only partially solved. In September 2017 the Economic 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.

The Italian delegation raised immediately several country-specific arguments related to the estimation of NAWRU and to the trend/cycle decomposition of TFP, and proposed some country-specific enhancements to the methodology. Details on the Italian technical proposals were published in the 2018 Stability Program[3].

With reference to the NAWRU, Italy's proposal envisages the use of an iterative procedure, the so-called Grid Search, which, on the basis of a set of statistical criteria, selects the initial variance bounds of the model in a less discretionary fashion than previously foreseen. Thanks to the Grid Search procedure, the NAWRU estimates for Italy are sounder from a statistical point of view and less pro-cyclical than those produced by the

[2] 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

[3] 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

standard approach. The EPC and the European Commission agreed to adopt the Grid Search, initially for Italy and subsequently for all EU Member States.

Italy also proposed two changes in the estimation of the TFP. The first one concerned the calculation of the index of capacity utilization (CUBS) currently adopted for the trend-cycle decomposition of TFP. A compromise solution was found and has been used by the European Commission since the 2018 Spring Forecasts[4].

The second, and most relevant, proposal envisaged the possibility of adding a measure of labor hoarding to the CUBS index to help decompose the TFP trend and cycle components. The labor hoarding indicator was based on data concerning the ordinary and extraordinary Cassa Integrazione Guadagni (CIG, the wage-supplementation fund) requested by companies. This proposal was not endorsed by the OGWG, as the labor hoarding index was viewed as sensitive to discretionary policy changes that might have influenced its cyclical properties.

Overall, the NAWRU and TFP proposals that were endorsed by the OGWG improved the estimation of Italy's potential output, but only to a limited extent.

As far as the Commission's estimates are concerned, the 2018 Autumn Forecasts, which were recently published by the Commission, point to an annual average TFP trend growth rate for Italy of 0,1 percent for the 2018-2020 period and 0,2 percent for the next decade (2019-2029).

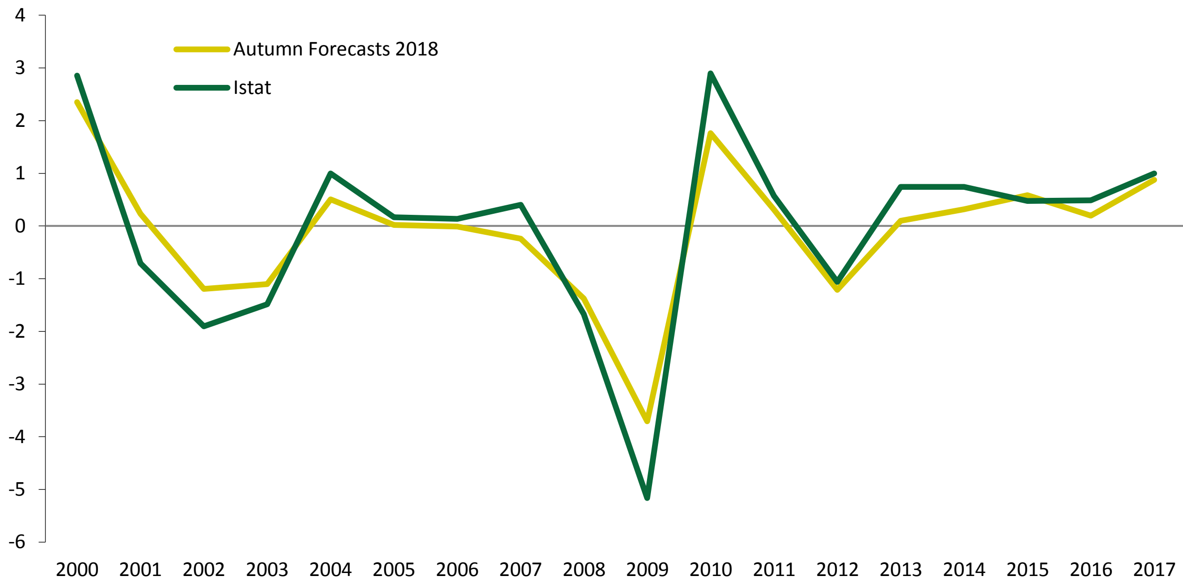
By mean of statistical filters, this variable is projected further onwards, beyond the short term forecasts horizon. These estimates contribute, as a fundamental driver of economic growth, to the production of medium and long term projections. On the basis of the above numbers crucial sustainability analysis is then curried out, whose results are summarized by the S1 and S2 sustainability indicators. In turn, these indicators feed back into the medium term fiscal surveillance process, for instance by entering the minimum Medium-term Objective (MTO) computation.

The TFP projections of the Commission for Italy are significantly lower than the estimates recently published by the Italian Statistical Office (Istat), which indicate an average TFP growth in 2014-2017 of 0.7 versus the 0.5 estimated by the Commission's 2018 Autumn Forecast (see Figure III.1).

Italy's proposal involving the labor-hoarding index would at least alleviate the issue of the negative TFP trend growth. In figure III.1 the alternative methodology has been applied to both the macroeconomic policy scenario of Italy's Update of the 2018 Stability Program and the Commission's 2018 Autumn Forecast, producing estimates that are significantly different from those obtained using the commonly agreed methodology. In particular, potential output growth, as estimated in the enhanced methodology, is less pro-cyclical than in the current agreed production function approach. The level of potential output is higher over the historical sample as well as in the 2018-2021 forecast period, yielding an output gap that remains in negative territory until the end of the projection horizon.

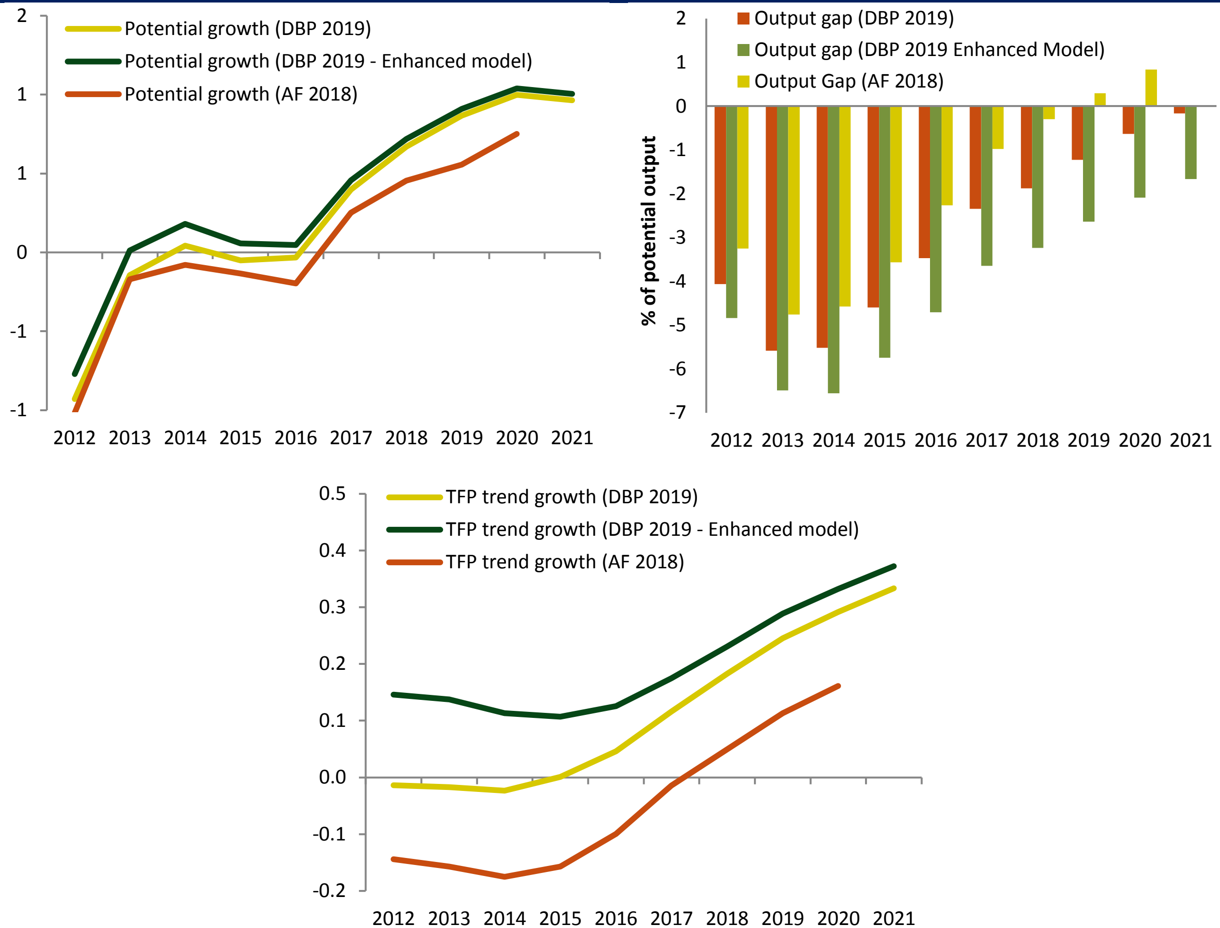
[4] Italy originally asked to replace, for the calculation of the CUBS, the services sentiment indicator with the corresponding capacity utilization index (available only from 2010), but, since no compromise solution had been reached for the backward reconstruction of the capacity index used in services, Italy 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.

FIGURE III.1 – TOTAL FACTOR PRODUCTIVITY GROWTH



Source: Istat and Commission Services Autumn Forecasts 2018.

FIGURE III.2 – ALTERNATIVE POTENTIAL GROWTH AND OUTPUT GAP ESTIMATES



Source: MEF simulations on 2019 DBP and on Commission Services Autumn Forecasts 2018.

A further issue, not yet brought to the attention of the OGWG, emerged after the publication of the 2017 Autumn Forecast a year ago. It concerns the estimate of the so-called structural unemployment rate, i.e. the anchor towards which the NAWRU is projected to converge over the medium term.

Currently the anchor is calculated with a panel model that regresses the NAWRU values obtained with the Kalman Filter model for the EU-15 member states on labour market variables considered structural (such as the rate of replacement of unemployment benefits, the tax wedge, the union density and 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 series used to measure the replacement rate of unemployment benefits exhibit an erratic pattern that does not adequately reflect the data. In particular, the sudden growth recorded from 2015 in the update of the dataset made in the autumn of 2017 seems implausible and produces a substantial worsening in the value of the anchor. Italy made an empirical proposal, which was not accepted[5]. The estimation of the NAWRU anchor is an issue that should be further investigated, as agreed within the EPC-OGWG.

Summing up, despite welcome improvements, significant challenges remain in the estimation of potential output for the Italian economy within the commonly agreed methodology. Further enhancements are necessary via a constructive dialogue at the level of the EPC committee and its OGWG subcommittee. Improved potential output medium term projections would be an important ingredient in achieving a common understanding of Italy's fiscal stance.

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

Potential output and output gap calculations are critical factors in evaluating the fiscal stance of a country. Under the preventive arm of the SGP, compliance with the required fiscal effort hinges on the way cyclical conditions are assessed on a two-year horizon (in this occurrence the 2018-2019 period); however, EU member countries are also engaged in providing guidance on their budget policy in the medium term.

The table below provides structural balance estimates consistent with alternative output gap and potential growth estimates on a four-year horizon; the table also accounts for projections of the aggregates consistent with the expenditure rule. We consider three possible alternatives: the Commission's Autumn Forecast 2018, the policy scenario presented in Italy's DBP 2019 and the same with the output gap calculated with the enhanced model.

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[5] The way out initially adopted by Italy was to overcome the irregularity of the data in some specific points of the series, by introducing a correction in the calculation of the value of the anchor in the enhanced model, which consisted 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 was similar to that 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 Commission Services 2018 Spring Forecasts estimates would decrease from almost 10 percent to 8.3 percent.

The table highlights how compliance with the preventive arm of the Stability and Growth Pact in 2018 and 2019 changes depending on the different output gap estimates. The situation concerning the two-year period 2018-2019, from the standpoint of the approach followed under the preventive arm procedure can be summarized as follows.

The Commission's 2018 Autumn Forecasts signal the return to normal cyclical conditions as early as 2017, estimating the output gap above -1.5 percent . Consequently, according to the matrix that quantifies the fiscal adjustments required in relation to the cyclical conditions of the economy, in the 2018-2019 period it would be necessary to improve the structural balance by at least 0.6 percentage points each year.

However, the European Commission, in the context of the Communications about the 2017 European Semester, announced that the assessment of compliance with the requirements of the Stability and Growth Pact would apply a margin of discretion.

TABLE III.1 – COMPLIANCE WITH THE PREVENTIVE ARM OF THE STABILITY AND GROWTH PACT UNDER DIFFERENT OUTPUT GAP SPECIFICATIONS

Convergence to the MTO	DBP 2019		DBP 2019 Enhanced methodology for the estimations of Output Gaps		Autumn forecast 2018	
	2018	2019	2018	2019	2018	2019
Output Gap	-1.88	-1.23	-3.23	-2.64	-0.29	0.30
Potential Growth	0.7	0.9	0.7	0.9	0.5	0.6
Cyclical Position	Bad times	Normal times	Very bad times	Bad times	Normal times	Normal times
General Government deficit (%of GDP)	-1.84	-2.42	-1.84	-2.42	-1.93	-2.88
Medium Term Objective (MTO)	0.00	0.00	0.00	0.00	0.00	0.00
Structural deficit(% of GDP)	-0.90	-1.72	-0.17	-0.96	-1.84	-2.99
A=change in the structural deficit	0.20	-0.81	0.23	-0.79	0.01	-1.15
B=required change in the structural deficit	0.30	0.60	0.30	0.50	0.30	0.60
C=A-B (no more than-0.5pp) Annual deviation from the required change in the structural balance	-0.10	-1.413	-0.07	-1.285	-0.29	-1.8
D=Two-year average change in the structural balance	-0.02	-0.31	0.02	-0.28	-0.15	-0.57
E=Required Two-year average change in the structural balance	0.20	0.45	0.08	0.40	0.25	0.45
F= D-E (no more than -0.25pp) Deviation of the two-year average change in the structural balance from the required values	-0.22	-0.76	-0.06	-0.68	-0.41	-1.02

Source: MEF simulations on 2019 DBP and on Commission Services Autumn Forecasts 2018.

The aim was to take into consideration the objective of achieving a fiscal stance capable of strengthening the growth prospects and at the same time guaranteeing the sustainability of public finances in the Euro Area. Based on this premise, the Commission deemed that the 0.3 percentage point improvement in the structural balance envisaged in Italy's Draft Budgetary Plan 2018 was adequate.

Current estimates of changes in the structural balance for 2018 indicate an improvement that varies between zero according to the Commission Autumn forecast to 0.2 percentage points under the enhanced methodology applied to the 2019 DPB headline data. The final assessment of compliance with the required adjustment in 2018 must await the final budget and GDP figures for this year, but in the meantime the estimates produced with the enhanced methodology suggest that there is no clearcut evidence of a deviation from what was agreed with the Commission.

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

Expenditure Rule	DBP 2019		DBP 2019 Enhanced methodology for the estimations of Output Gaps		Autumn forecast 2018	
	2018	2019	2018	2019	2018	2019
A = Annual growth rate in the reference expenditure aggregate (%, in real terms until 2017 then % in nominal terms)	1.30	2.76	1.30	2.76	2.27	3.59
B = Benchmark (modulated over the prevailing cyclical condition +flexibility clauses) (%)	0.50	0.10	0.50	0.33	0.50	0.10
C = (no more than-0.5pp) Annual deviation of the expenditure aggregate from the reference determined by the benchmark(% of GDP)	-0.35	-1.14	-0.35	-1.04	-0.77	-1.51
D = (no more than -0.25 pp) Two-year deviation of the expenditure aggregate from the reference determined by the benchmark (% of GDP)	-0.31	-0.74	-0.19	-0.69	-0.52	-1.14

Source: MEF simulations on 2019 DBP and on Commission Services Autumn Forecasts 2018.

Looking forward, the fiscal targets for 2019-2021 presented in the 2019 DBP imply a temporary deviation from the path of convergence of the structural budget balance towards the MTO. However, the extent of this deviation is greatly influenced by the deficit and output gap estimates, and is far more limited than suggested by the Autumn Forecast if Italy's estimates and the enhanced methodology are adopted. In fact, if the enhanced methodology is adopted, a different picture of the past and future fiscal stance emerges. The size of the output gap is such that Italy remains in "bad-times" until 2021. The structural balance is still estimated to deteriorate from -0.2 in 2018 to -1.0 in 2019, but it is unchanged in 2020 and 2021, suggesting that Italy would no longer be deviating from the convergence path to the MTO and the subsequent adjustment would be relatively small, one percent of GDP.

III.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 III.3 shows the gaps with the debt reduction benchmarks in all debt rule configurations for 2018 both under the current policy scenario of the 2019 DBP and under the no-policy change assumption (i.e. maintaining the Budget to GDP ratio at its 2019 level) featuring the Commission services Autumn Forecasts.

According to both sets of projections, Italy is not compliant for the year 2017 in any of the debt rule configurations. In particular, 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-inflation and concrete risks of deflation, the gap to the cyclically-adjusted debt benchmark is estimated to be substantial in 2018.

According to the 2018 Commission services Autumn 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 the cyclically-adjusted debt index would be even higher than the one recorded on the basis of the backward-looking configuration[6].

We maintain the view that such result seems to be counterintuitive and mostly due to the implausible negative TFP trend growth estimates that lead to negative and pro-cyclical potential output growth rates for Italy; therefore we reiterate the following line of argument laid down in the previous Report on Relevant Factors of May 2018.

When potential growth is estimated to be negative or in any case lower than the actual figures, the debt rule in the cyclically-adjusted configuration may completely fail in its intention. The European Commission itself has recognized that the cyclically adjusted debt-reduction benchmark does not fully capture the impact of very low inflation over extended periods[7].

Therefore, the protracted subdued nominal GDP growth experienced by Italy in the last years could still undermine compliance with the debt rule, even when assessed on the basis of the cyclically adjusted debt level.

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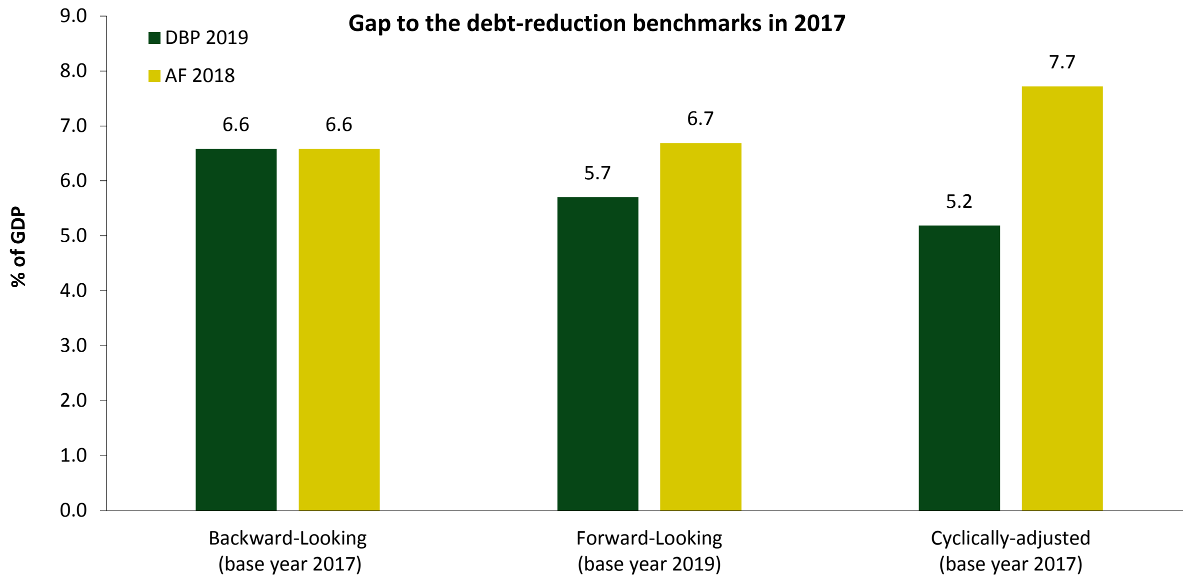
[6] In this respect, the formula used to cyclically adjust the debt-to-GDP ratio in the framework of the SGP debt rule subtracts, in the numerator, the cyclical component of the budget balance of the current and previous two years, from the current year debt level. Similarly, the level of GDP in the 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.

[7] See the European Commission Reply to the Report of the Court of Auditors, European Court of Auditors, Special Report No 10/2016, Further improvements needed to ensure effective implementation of the excessive deficit procedure.

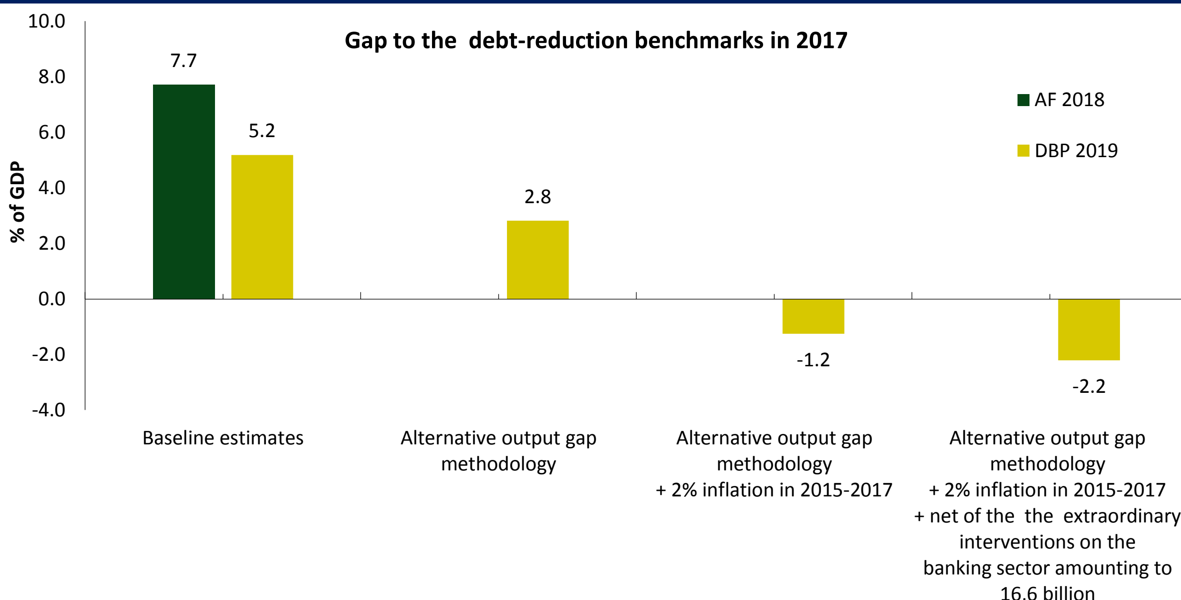
FIGURE III.3 – GAPS TO THE DEBT REDUCTION BENCHMARKS: RESULTS FROM THE 2019 DRAFT BUDGETARY PLAN VS 2018 AUTUMN FORECASTS



Source: MEF elaborations on 2019 DBP and on Commission Services 2018 Autumn Forecasts.

Given such backdrop, Figure III.4 shows how the cyclically-adjusted gap to the benchmark derived for 2017 on the basis of the 2019 DBP would change if the enhanced production function methodology developed by the Italian Treasury was used to estimate potential growth and output gaps.

FIGURE III.4 – GAPS TO THE DEBT REDUCTION BENCHMARKS IN THE CYCLICALLY-ADJUSTED CONFIGURATION AND WITH THE ENHANCED PRODUCTION FUNCTION METHODOLOGY



Source: MEF simulations on 2019 DBP and on 2018 Commission Services Autumn Forecasts.

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 almost halved under the 2019 DBP scenario.

Furthermore, by assuming a GDP deflator growth at 2 percent[8] per year over the period 2015-2017, Italy would comply with the debt rule on the basis of the cyclically adjusted specification. As a matter of fact, it turns out that the gap to the debt-reduction benchmark in the 2019 DBP scenario would be negative and equal to -1.2 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), the gap to the debt-reduction benchmark in the 2019 DBP scenario would further reduce to -2.2 percent of GDP.

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

IV. NEW POLICIES FOR SOCIAL INCLUSION

IV.1 SOCIAL INCLUSION POLICY

Social vulnerability has increased in most EU countries in the aftermath of the global financial crisis. As a result, the issue of how to tackle poverty and inequality has gradually moved to the top of the policy agenda of European institutions and Member States. In particular, the social dimension, highlighted in the TFEU as one of the Union's objectives ('social cohesion'), has been taken up explicitly in the Europe 2020 strategy for growth and jobs. More recently, structural reforms and specific policies, essential to foster social convergence, are guided by the European Pillar of Social Rights within the European Semester. The Joint Employment Report (JER) 2018, the Country Report Italy 2018 and the CSRs 2018, all urged Italy to improve social inclusion,

In Italy, the legacy of the crisis in terms of unemployment, poverty and social inclusion has been harsh. Income inequality has worsened and the social and income gap vis-à-vis other Euro area countries has widened.

EU measures addressing the risk of poverty and social exclusion are included in the Social Scoreboard linked to the European Pillar of Social Rights[9]. At the European level, people are considered at risk of poverty and social exclusion (AROPE) when they experience one or more of the following three conditions: a) being at risk of poverty[10]; b) being severely materially deprived[11]; c) living in a household with a very low work intensity[12].

In the 2005-2017 period the AROPE rate shows a stable trend at EA-19 level (and at EU-28 level since 2010) but country differences emerge looking at Figure IV.1. For the whole period, AROPE levels are lower for France and Germany compared to Italy and Spain. After the 2008 crisis, AROPE rose in the two latter countries, recording higher levels in Italy (except for 2014). Furthermore, in 2007 AROPE in Italy was 4.1 percentage points higher than the EA-19 average and the gap widened to 6.8 percentage points in 2017. In particular, AROPE peaked in 2016 (30 percent, +6.9 on EA-19 average), increasing by 4 percentage points over 2007, and declined only moderately in 2017, reaching 28.9 percent.

Concerning the national target on poverty and social exclusion in the framework of Europe 2020 Strategy, Italy should reduce by 2.2 million individuals in combined poverty compared to the value recorded in 2008 (base year for Europe 2020). In particular, in that

[9] An annual overview on labour market and social indicators is provided by the *Joint Employment Report* (2018), which also monitors Member States' performance in relation to the European Pillar of Social Rights. Data are also available at: https://ec.europa.eu/eurostat/web/european-pillar-of-social-rights/indicators/main-tables.

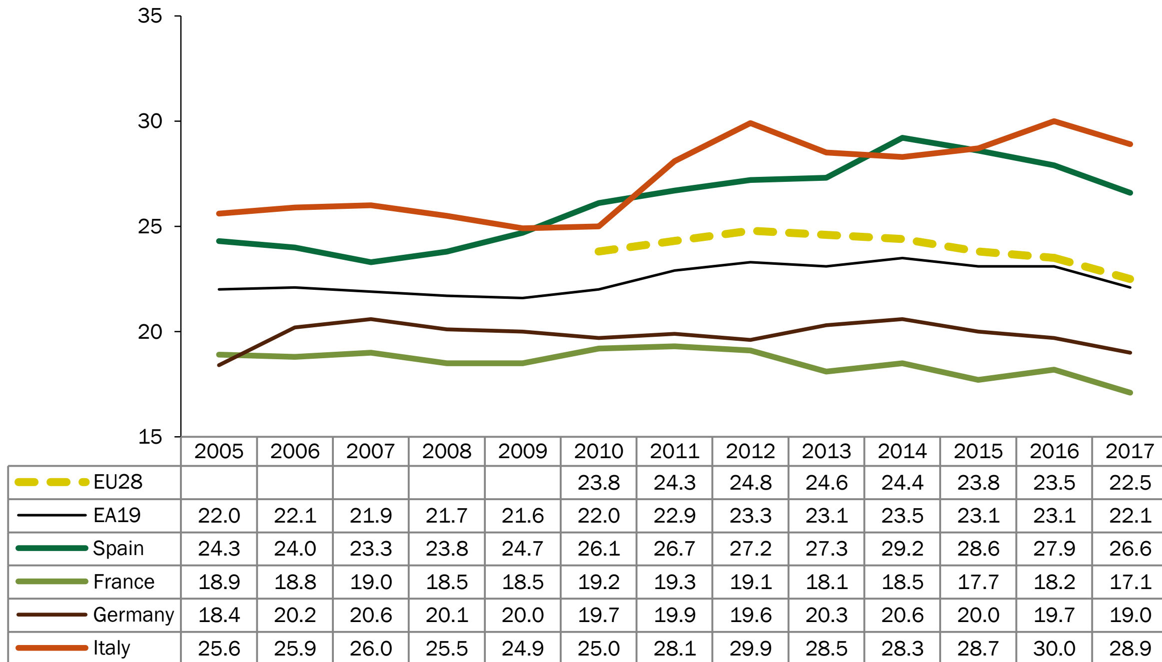
[10] This condition implies living in a household with an equivalised disposable income below the 60 percent of the national median equivalised disposable income.

[11] The indicator for severe material deprivation measures the share of persons who have living conditions severely constrained by a lack of resources. They experience at least 4 out of 9 following deprivations items: cannot afford i) to pay rent or utility bills, ii) keep home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) a week holiday away from home, vi) a car, vii) a washing machine, viii) a colour TV, or ix) a telephone. For details on the related indicator see: https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Material_deprivation.

[12] The corresponding indicator is defined as the number of persons living in a household where the members of working age worked less than 20 percent of their total potential during the previous 12 months.

year 15,082 thousand individuals were at risk of poverty or social exclusion; as a consequence, the national target to be reached by 2020 is 12,882 thousand individuals. In 2017, the population at risk of poverty or social exclusion (17,407 thousand individuals) was 4,525 thousand higher than the target for 2020, though diminishing compared to 2016.[13]

FIGURE IV.1 – PEOPLE AT RISK OF POVERTY AND SOCIAL EXCLUSION (AROPE), PERCENTAGE OF TOTAL POPULATION, 2005-2017(1)



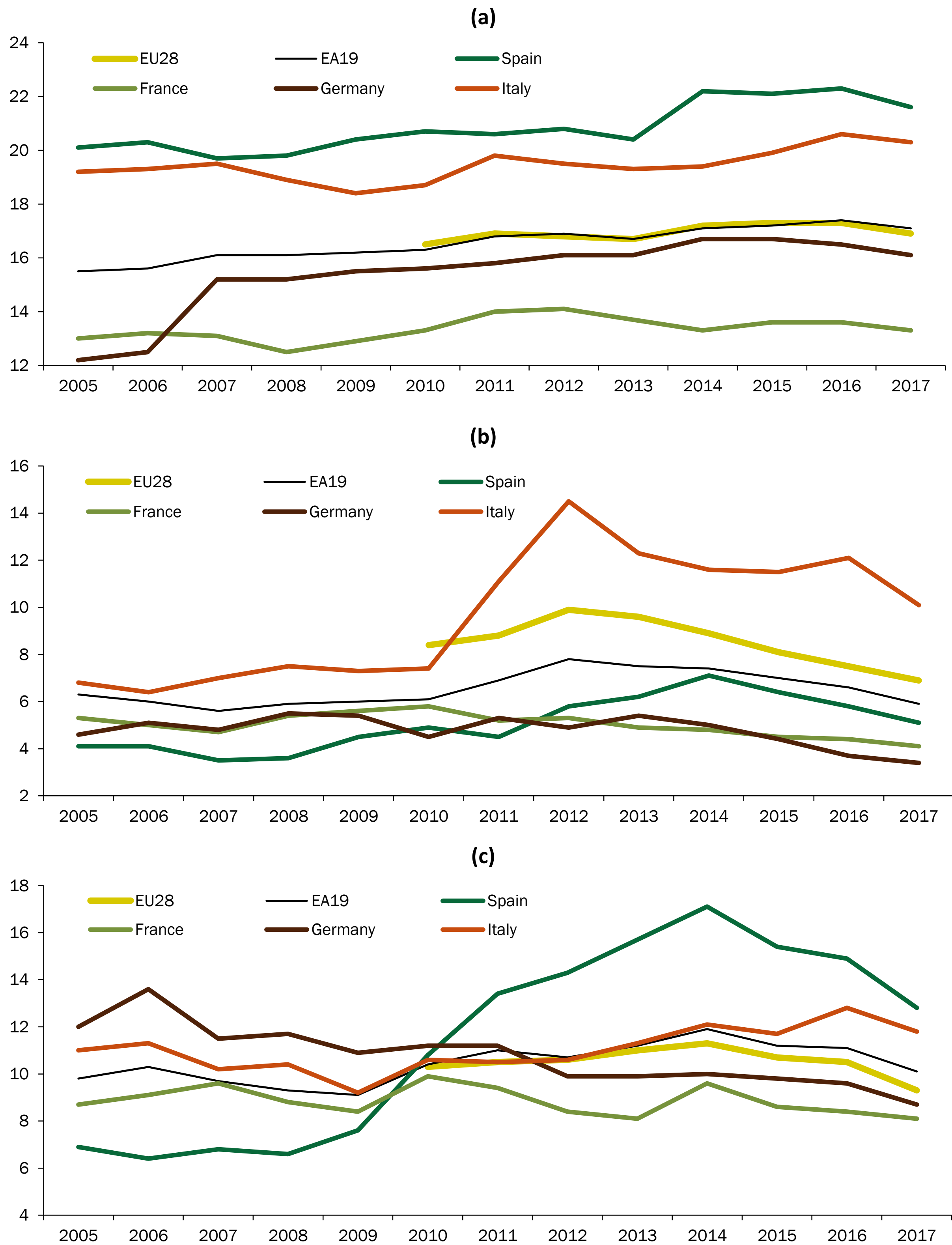
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
EU28						23.8	24.3	24.8	24.6	24.4	23.8	23.5	22.5
EA19	22.0	22.1	21.9	21.7	21.6	22.0	22.9	23.3	23.1	23.5	23.1	23.1	22.1
Spain	24.3	24.0	23.3	23.8	24.7	26.1	26.7	27.2	27.3	29.2	28.6	27.9	26.6
France	18.9	18.8	19.0	18.5	18.5	19.2	19.3	19.1	18.1	18.5	17.7	18.2	17.1
Germany	18.4	20.2	20.6	20.1	20.0	19.7	19.9	19.6	20.3	20.6	20.0	19.7	19.0
Italy	25.6	25.9	26.0	25.5	24.9	25.0	28.1	29.9	28.5	28.3	28.7	30.0	28.9

(1) The indicator refers to the year of the EU-SILC survey (t) but income data refer to the previous year (t-1).

Figure IV.2 reports data on the three underlying sub-indicators of AROPE: at risk of poverty rate (AROP), severe material deprivation rate, percentage of total population living in a household with a very low work intensity. Among these indicators, Italy scores particular high levels of the severe material deprivation rate for the whole period (Figure IV.2, panel (b)). More in detail, this indicator reports a significant increase in the years 2010-2012 (with a peak in 2012) only partially offset by a reduction in the most recent years. With regard to relative poverty (AROP), Italy records higher levels over the entire decade 2007-2017 compared to the EA-19 average (by around 3 percentage points on average); in 2017 AROP in Italy is 20.3 percent while the EA-19 average is 17.1 percent (Figure 2, panel (a)). As to the third indicator, the selected countries record very different performances, with an inversion of the top and bottom positions in the country ranking in 2017 compared to 2005 (Figure IV.2, panel (c)).

[13] https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/european-semester/european-semester-your-country/italy/europe-2020-targets-statistics-and-indicators-italy_en#poverty-and-social-exclusion.

FIGURE IV.2 – AT RISK OF POVERTY RATE (a), SEVERE MATERIAL DEPRIVATION RATE (b), PERCENTAGE OF TOTAL POPULATION LIVING IN A HOUSEHOLD WITH A VERY LOW WORK INTENSITY (c), 2005-2017 (1)



(1) The indicators refer to the year of the EU-SILC survey (t) but income data for the at-risk of poverty rate (a) refer to the previous year (t-1).

On account of these trends in poverty and inequality, improving Italy's social inclusion performance requires a substantial increase in income support for individuals and households. Moreover, as widely discussed in the Commission's latest Country Report (February 2018 – Box 4.3.1), Italy is also facing relevant challenges with respect to other indicators of the Social Scoreboard supporting the European Pillar of Social Rights, notably labour market conditions and inclusion. In addition to a very low overall employment rate, Italy shows large gender employment gaps and high rates of young unemployed and/or not in employment, nor in education or training (NEET). The employment gender gap is ten percentage points higher than the EU28 average in the period 2005-2017, reaching a value of 19.8% in 2017. With respect to NEETs 15-24, since 2010 Italy shows a value of around 20%, almost twice the EU28 average.

Against this background, Italy is strongly committed to improving social inclusion, combating precariousness, boosting youth employment and improving active labour market policies (ALMPs) and is making a significant effort to ensure compliance to the main principles of the European Pillar of Social Rights.

More specifically, concerning "*Equal opportunities and access to the labour market*", in relation to "*Active support to employment*"[14], the measures envisaged by the Commission are included in the "job-assistance" actions that Employment Services are intended to deliver, following the Job Centre reform package for which 1 billion Euro is allocated in the 2019 Budgetary Law. The basic guidelines of the Employment services' reform include a national plan, shared with Regions and Provinces which are entitled to operationally manage job centers at local level, aimed at:

- Increasing personnel for employment services and developing specific training for operators of job centers which need particular skills in view of the introduction of the 'citizenship income' policy. A recruitment plan for qualified staff will be implemented in addition to what was already defined in the 2018 Budget.
- Enhancing and integrating the information system at the national level, by implementing a standard software and a common labor information system across regions so as to:
  - improve matching between labour demand and supply, through the integration of data sets at the regional level and across institutions, the National institute for social security (INPS) and the National Agency for ALMPs (Anpal).
  - guarantee the same standard of services to all beneficiaries and users.

Concerning the chapter on "Social protection and inclusion", we would focus on the following specific European guidelines: Unemployment benefits[15] and Minimum Income[16]. In

[14] "Everyone has the right to timely and tailor-made assistance to improve employment or self-employment prospects. This includes the right to receive support for job search, training and re-qualification. Everyone has the right to transfer social protection and training entitlements during professional transitions. Young people have the right to continued education, apprenticeship, traineeship or a job offer of good standing within 4 months of becoming unemployed or leaving education. People unemployed have the right to personalised, continuous and consistent support. The long-term unemployed have the right to an in-depth individual assessment at the latest at 18 months of unemployment".

[15] "The unemployed have the right to adequate activation support from public employment services to (re)integrate in the labour market and adequate unemployment benefits of reasonable duration, in line with their contributions and national eligibility rules. Such benefits shall not constitute a disincentive for a quick return to employment".

this context, the ‘citizenship income’ is indeed a benefit delivered vis-à-vis the commitment of recipients to accept work and training opportunities.

Citizenship income is conceived as an activation tool combining an income support program with ALMPs with the dual goal of fighting poverty and helping people enter the labour market, thus also improving productivity through investment in human capital. Although the details of the measure are currently under examination of the competent authorities, the general design of the new scheme of income support is defined. It will supplement the labour or pension income of people whose income is below the relative poverty line of EUR 780 per month, and it will also take into consideration dependent minors living in the household of beneficiaries. It is a means-tested policy, that will therefore target only the poorest groups of the population. For people of working age the allowance will be conditional upon active job search and acceptance of job offers.

An incentive system, promoting the declaration of prior informal work positions and penalties in case of illegal and/or irregular work are also envisaged. Moreover, the qualitative and quantitative strengthening of job centres (in terms of human resources and infrastructure) to guarantee the effective implementation and monitoring of services provided is an integral part of the reform package. The aim to ensure that services are provided homogeneously throughout the nation.

On the subject of inclusion, it is also worth mentioning the Legislative Decree n.87/2018 (so called Dignity Decree), issued in July 2018 and converted by Law No 96/2018, which aims to promote permanent employment and discourage the use of temporary contracts by reducing the scope for their renewal[17].

In addition, in 2019 and 2020, private employers will be exempted from 50 percent of social security contributions if they permanently hire under-35 years old. The 2019 Budget also extends the hiring incentive for Southern Italy with an endowment of up to 500 million euros per annum.

Incentives for private employers who hire young graduates or holders of doctorates through a permanent contract will also be extended. They take the form of an exemption from social security contributions paid by the employer for a maximum period of 12 months starting from the date of employment, up to € 8,000 per new hire.

[16] “Everyone lacking sufficient resources has the right to adequate minimum income benefits ensuring a life in dignity at all stages of life, and effective access to enabling goods and services. For those who can work, minimum income benefits should be combined with incentives to (re)integrate into the labour market”.

[17] More specifically the decree has: capped to 30 percent the number of temporary contracts versus permanent ones in the same company; foreseen the conversion of temporary contracts without a justification into permanent ones after 12 months (instead of 36 as previously); increased by 50 percent the compensation for unjustified dismissals up to 36 months; prolonged until 2020 the 50 percent reduction on social security contributions for new permanent hiring of young people under 35; limited the use of vouchers.

V. STRUCTURAL REFORMS

V.1 THE REFORM AGENDA

The European Council's recommendations to Italy for this year are centred, as in 2017, around four main areas: i) fiscal policy, i.e. improving the structural balance, reducing the debt ratio, reforming certain aspects of taxation and combating evasion; ii) anticorruption and justice, together with SOEs and quality of public services and competition policy; iii) access to finance, through banks restructuring and consolidation and the insolvency reform; iv) labour market policies, i.e. job-search assistance and training, encouraging labour market participation of women, research, innovation and vocational oriented tertiary education. These recommendations were also addressed to Italy with the goal of correcting its macroeconomic imbalances, identified by the Commission in Spring 2018 and related in particular to high public debt and allegedly weak productivity growth.

In line with the Commission recommendations the Government is putting in place a number of measures (see table below) to improve the growth potential of the economy and close the growth gap with the rest of Europe. Together with a fairer income distribution among citizens and enhanced social inclusion policies, this strategy will boost employment and income, as well investment.

In order to achieve these objectives the Government will boost investment and the implementation of further structural reforms while supporting the disposable income of households, especially the poorer ones. All these efforts will be made without disregarding the country's objective of debt reduction. On the expenditure side, the spending review will be oriented to reducing the ratio between current government expenditure and GDP and increasing investment spending.

From a fiscal policy perspective, the Government plans to gradually reduce the tax burden on households and businesses and to make taxation more growth-friendly. The 2019 Draft Budget Law gradually revises the system of direct taxation in the medium term, while reducing the fiscal pressure on both labour and business income.

This objective will be pursued - in the first phase - by supporting small activities of individual entrepreneurs and self-employed. Accordingly, from 2019, the revenue ceiling for the existing flat tax scheme for self-employed (with a 15 percent rate) will be raised to 65,000 euro (previously between 25,000 and 50,000 according to the profession or sector of activity), also eliminating some requirements related to instrumental assets and personnel costs. As of 2020, self-employed with earnings between 65,000 and 100,000 euro will be eligible for a new unique regime replacing the IRPEF and IRAP regimes: a 20 percent tax rate will be applied to business income.

With the same law, the substitute tax rate (21 percent) on rents from commercial properties (instead of the ordinary PIT) is extended to rent agreements stipulated in 2019. The government does not consider appropriate to revise the taxation of principal property. However, a gradual process of cadastral data integration is currently underway, and a new platform for the management of the Cadastre will improve the inter-operability between administrative, cartographic and cadastral archives.

MAIN STRUCTURAL REFORMS IN 2018			
	Areas	Policy Area	Actions
1	Debt and public finances	Public finances	Debt reduction
2		Public finances	Spending review
3		Public finances	Reducing delays in payments in the Public Administration
4		Public finances	Strengthening the public debt reduction strategy through privatizations, real estate dismissals and concessions reform
5	Taxes ,spending review and fight against tax evasion	Tax policies	Tax cuts to support growth (*flat tax, tax expenditures*, excise duties and tax wedge)
6		Tax policies	Coordination, enhancement and simplification of the tax administration ('*pace fiscale*')
7		Tax policies	Investments in ICT and human resources to support the fight against tax evasion and to encourage tax compliance
8		Tax policies	Tax disputes reduction and improvement of tax collection efficacy
9	Credit	Banks and Loans	Reduction of non-performing loans
10		Banks and Loans	Revision of the regulation applied to firms crisis and insolvency (Delegated Law)
11		Banks and Loans	Extraordinary administration for large enterprises in state of insolvency
12		Banks and Loans	Foreign investment attraction and assessment of measures alternative to bank loans
13	Labour, welfare and productivity	Labour and welfare	Strengthening of the Job-placement centres
14		Labour and welfare	Citizenship income
15		Labour and welfare	Measures to support households and disability
16		Labour and welfare	Support to female and youth employment and policies in favour of second wage earners
17		Labour and welfare	Measures to strengthen equity in the pension system
18		Labour and welfare	Measures for the dignity of workers and for businesses
19		Labour and welfare	Extraordinary hiring plan for healthcare professionals ('White Jobs')
20		Education and skills	National training plan for teachers
21		Education and skills	Full implementation National Plan for Digital Education
22		Education and skills	National Plan for Inclusive Education
23		Education and skills	National Research Programme
24	Investment and regional imbalances	Investment	National Plan for Public Investments and strengthening of PPPs
25		Investment	Revision of procurement legislation and assessment of existing measures
26		Regional imbalances	Measures for the South with access to dedicated resources ('*Patti per il Sud*')
27		Regional imbalances	Tax credits to private investments and incentives to capital expenditures in the South
28	Competitiveness	Competitiveness	Implementation of the harbour reform and National Plan for Harbours and Logistics
29		Competitiveness	Measures addressing the hydrogeological instability and seismic risk ('*Casa Italia*')
30		Competitiveness	Business development: 4.0 Business Plan and fight to firms relocation
31		Competitiveness	Internationalization, Competitiveness and Made in Italy
32		Competitiveness	Start-up and innovative SMEs, Blockchain and Artificial Intelligence
33		Competitiveness	Strategic plan for tourism and cultural heritage
34		Competitiveness	Biodiversity, sustainable mobility, integrated water services and measures for the circular economy
35		Competitiveness	Liberalization and competition
36		Health	Implementation of the Health Pact and Digital Health
37		PA	Simplification for businesses and citizens
38		PA	Rationalization of State-owned companies
39		PA	Reform of local public services to enhance quality and efficiency
40		PA	Reform of public management
41		PA	Full implementation of the Simplification Agenda, launch of a 3-year ITC Plan for the PA and measures to ensure greater cyber security
42		Judicial system	Reform of criminal trials and statute of limitations
43		Judicial system	Fight against organized crime and illicit assets
44		Judicial system	Reform of the prison system
45		Judicial system	Crimes against the PA and fight against corruption
46		Judicial system	Efficiency of civil trials
47	Other	Immigration and safety	Fight against irregular immigration and public security
48		Constitutional reforms	Reduction of the members of Parliament, abolition of CNEL, direct democracy

A number of actions have been taken mainly aiming at improving the efficiency of the tax collection system by eliminating tax arrears and collection delays and by simplifying tax dispute resolution procedures. A decree attached to the 2019 Draft Budget Law will – among others - recognize a preferential treatment to taxpayers in order to further reduce and simplify pending tax disputes and will repeal tax debts below 1,000 euro created from 2000 to 2010. The aim of these provisions is essentially to remove tax disputes in all those exceptional and unintentional situations of proven financial difficulties. In this respect they will support taxpayers with significant liquidity constraints while improving the cooperation between the Tax administration and citizens.

The fight against tax evasion will be pursued by strengthening all available instruments, in particular by using new technologies to carry out targeted cross-checks. In this respect the electronic invoicing among private- already compulsory since the 2018 Budget Law – will be reinforced with the obligation of the storage and electronic transmission of receipts to the Revenue Agency. Data available from the integration between e-invoices and online transmission of payments related to transactions to final consumers will be used to increase the effectiveness of tax controls.

The Government will devote a special effort to reversing the negative trend in public investment that has been in place for many years. To give some figures, this year public investment is likely to reach a new low of 1.9 percent of GDP (from an average of 3.0 percent in the decade prior to the sovereign debt crisis in 2011). In this context, the Government has allocated almost 150 billion over a 15 year period for new investments, around 118 billion of which immediately available. Moreover, additional 15 billion over the next three years will be allocated by the 2019 Draft Budget Law.

The management and planning capacity of public administrations (central and local) will be strengthened. Public and private synergies will be stimulated through enhanced Public-Private Partnership. The definition of a standard PPP contract (already in an advanced stage of development) will play a major role, together with the foreseen amendment to the Code of Public Procurement. The amendment will essentially overcome uncertainties that have emerged, simplify procedures and promote transparency. A dedicated Task force is in place to centralise information on ongoing projects, promote monitoring, evaluation and coordination of investments and share best practices. An expertise centre will be set up to provide technical assistance for the preparation and evaluation of projects by public administrations.

Infrastructural investment is at the core of Government strategy and priority will be given to a network of small works to repair, where possible, or to replace, where necessary, the existing infrastructure with particular attention to roads and safety of bridges, tunnels and internal roads. The promotion of regional rail transport and local public transport, the reduction of road victims though innovative road infrastructures, the sustainable mobility, and the strengthening of ports and airports, also by improving their connectivity, are all part of the Government's investment strategy.

In the last months significant efforts have been made to manage urgencies such as the ones created by the collapse of the motorway bridge in Genoa, showing the urgent need of maintenance and modernization of the country's infrastructures. The emergency decree approved by the Government aims to accelerate the demolition and reconstruction of the 'Morandi' viaduct in Genoa and to support the victims of the collapse through: tax facilitation measures for firms involved and for the full recovery of port traffics; the

establishment of an urban free zone and a simplified logistics area for the port and the back port; immediate measures to assist the road traffic and connections into and out the port of Genoa, implementing local public transport. A Special Commissioner has been appointed to speed up the rebuilding of the damaged infrastructures and implement the necessary actions to overcome the consequences of the harmful events.

Among the sectors that have the greatest impact on economic performance, the legal and judicial system plays a prominent role. To this end the Government is putting in place a wide range of actions concerning both civil and criminal justice aimed at improving the justice system and strongly opposing corruption in public and private institutions.

In order to further reduce the large backlog of pending civil proceedings, the Government is considering a proposal for the simplification of civil trials through the introduction of a single simplified procedure. To this aim, also the 'digital trial' will be further enhanced and staffing shortages (both judges and administrative staff) will be addressed. The reform effort in the criminal sector concerns two main areas: the reform of the statute of limitations and the review of the anticorruption legislation. In the latter field, a draft law has been recently presented to the Parliament. It significantly impacts on the actual system with the aim of strengthening the prevention, detection and prosecution of criminal offences against the public administration, punishing corruption as the most serious crimes. The main innovations concern the aggravation of penalties both in terms of imprisonment and prohibition to access contracts and public offices. The Government also intends to address the conditions and operation of the penitentiary system. Finally, the reform effort concerns insolvency procedures: a legislative decree has been recently adopted to achieve a unitary regulatory framework through the introduction of the Code of corporate crisis and insolvency procedures.

Accelerating insolvency procedures would speed up firms restructuring, increase investment and improve the business environment and the economic growth. In this respect the Government is also working to support productive activities acting on a wide range of areas, from taxation to administrative simplification and protection of business in crisis.

First, in order to strengthen the presence of Italian firms in foreign markets, the Government intends to support both internationalization - especially for SMEs - and foreign investments. To attract inward investment, the Government plans to introduce administrative simplifications, to facilitate the access to credit and to make insolvency management less costly. Particular attention will be paid to venture capital investment by lunching a public platform to finance highly dynamic SMEs with shares of pension savings; the creation of a specific fund to sustain Venture Capital is foreseen by the 2019 Draft Budget Law. The SME Guarantee Fund will be strengthen and a Bank for investment with an explicit public guarantee will be established. Also the use of Individual savings plans (PIR) will be eased and some efforts will be made to protect the Made in Italy, mainly fighting against counterfeiting. The Government plans to reduce administrative costs for start-ups and to revise the Public Procurement Code limiting subcontracting, making payments by public authorities more efficient and facilitating the extension of the compensation of tax credits with tax dues. In view of the positive outcome of the Plan '*Impresa 4.0*', the Government works to either confirm or extend some of its measures. The 2019 Draft Budget Law for instance, extends the hyper-depreciation to new acquisitions of highly technological capital goods for 2019 making it more targeted at fostering technological and digital transformation. As a consequence, the Super-depreciation will be repealed. The 2019 Draft Budget Law also foresees a revision of the R&D tax credit with a reduction in the percentage

of the deductible income in 2019, the refinancing of the measure '*Nuova Sabatini*' and the creation of a specific fund to promote innovative technologies such as Blockchain, Internet of things and the Artificial Intelligence. Finally, the Government intends to approve the new annual law on competition.

In order to support business activities in the South, the 2019 Draft Budget Law confirms and extends some of the measures adopted in the past such as the 100 percent discount on social security contributions to hire young unemployed in Southern regions and the measure '*Resto al Sud*'.

Among the barriers hindering investment, productivity growth and a sound business environment, the inefficiency of public administration play a central role. The Government is strongly committed to modernizing this sector and has tabled a comprehensive proposal to enhance the PA efficiency by favouring intergenerational mobility and fighting absenteeism. The capacity of the administration will be strengthen by improving local managers skills and reforming public managers' contracts. A three-year plan for the ICT will be launched so as to foster the digitalisation of public services. New digital administrative procedures will be introduced to favour simplification and cost reduction for citizens and business.

In the field of education the Government will introduce incentives to early access to primary education so as to strengthen the 'Integrated Education System'. Reform of primary, secondary and tertiary education is in the pipeline, with a special attention to ensure the right to study to disabled students. The recruitment system for teachers will be revised and simplified so as to ensure an adequate and competent personnel. For universities, the Government has allocated additional resources for hiring about 1,000 new researchers in the next two years. For students, significant resources will be granted to scholarships and they will benefit from an extension of the no-tax area. In 2019 the Government will support new secondary education technical courses (ITS) with 50 million. Finally, the Government is committed to fully implement the National Plan for the Digital School.

Taking into account the present demographic crisis and the high level of the old-age dependency ratio reported by Italy, the adoption of measures to support families represents a priority for the Government that plans to set up a family-friendly tax system and to strengthen the network of family support services, to innovate the instruments in support of maternity and to further facilitate the work-life balance. Moreover, the Government intends to reform the legislation related to the rights of persons with disabilities and to increase the resources to support the role of caregivers.

The main environmental challenges that Italy is facing relate to climate change, the conservation of terrestrial and marine biodiversity, soil consumption and the sustainable use of resources. In order to take into account all these challenges, the Government will fulfill the commitments signed at European, regional and international level and will implement different measures at the national level. With regard to environmental protection and alternative energy for instance, the Government will promote a sustainable development model (the so-called 'circular economy') by streamlining and harmonising environmental legislation on waste. Moreover, all these topics will be implemented in the Integrated National Energy and Climate Plan that will be launched by the end of 2019 to meet the European 2030 targets.

VI. DEBT SUSTAINABILITY

A key premise of the economic policy approach taken by the Government is that Italy's public debt, while admittedly high as a share of GDP, is sustainable and affordable. In this chapter, consistent with the approach traditionally followed in the Stability Program, we update the analysis of debt sustainability and sensitivity to macroeconomic and financial shocks over different time horizons. The key finding is that although the new budgetary plan entails higher deficits in the near term, it does not materially worsen debt sustainability. If the program succeeds at raising the growth rate of real GDP, it will improve debt sustainability.

Debt sustainability is considered from different angles. In particular, the analysis focuses on the short, medium and long-term evolution of the debt-to-GDP ratio, consistent with the approach of the European Commisison[18].

VI.1 SHORT TERM ANALYSIS

According to the EU Commission, Italy falls into the low-risk category as far as the short term is concerned. The Commission uses the SO indicator to synthesize such a risk. The S0 is a composite index of risk of fiscal stress in the year ahead; it is calculated on the basis of two sub-indices incorporating, respectively, fiscal and financial-competitiveness variables; the latest assessment was carried out within the context of the Debt Sustainability Monitor. According to partially updated information, there should be no change in the evaluation once 2018 data are factored in.

Thanks to a stochastic debt simulation analysis, carried out by the Commission to grasp the sensitivity of debt-to-GDP projections to shocks hitting simultaneously GDP growth, the yield curve and the primary balance, it is possible to gauge the probability that the debt-to-GDP ratio in 2022 will be higher than the 2017 level. For Italy such probability is 33 percent and it is relatively low compared other EU Member States.

Stochastic simulations were carried out in order to provide a short-term sensitivity analysis of the performance of the debt-to-GDP ratio that simultaneously takes into account the uncertainty inherent in the yield curve and economic growth forecasts.

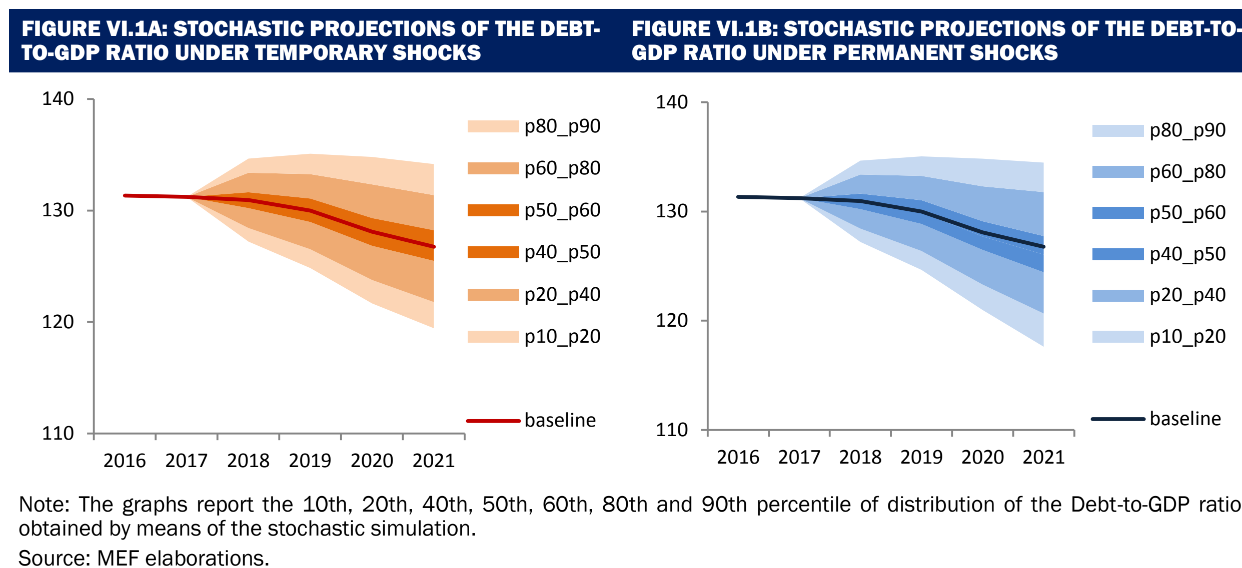
The simulations were carried out using the Montecarlo method, applying shocks to interest rates and nominal growth to the dynamics of the debt-to-GDP ratio relative to the planning scenario. These shocks are based on the historical volatility of returns (short and long term) and nominal GDP growth rate, and are obtained by executing 2000 extractions from a normal distribution with zero mean and variance-covariance matrix observed in the 1999-2017 period.

[18] The European Commission, relying on a multi-dimensional sustainability assessment, (2017 Debt Sustainability Monitor) considers three sustainability indicators, S0, S1 and S2, which identify risks over different time horizons. The S0 indicator provides an identification of sustainability challenges in the shorter term (up to 1 year), while the S1 and S2 indicators measure medium-term and long-term sustainability risks, respectively.

Two cases are analyzed: in the first one, the shocks to interest rates are transitory, in the second they are permanent. Nominal growth shocks are assumed to be temporary but they also affect the cyclical component of the primary surplus. As a result, for each year of projection and for each type of shock on interest rates (transitory or permanent) it is possible to identify a distribution of the debt-to-GDP ratio represented in probabilistic terms through a fan chart (Figures VI.1A and VI.1B).

FIGURE VI.1A: STOCHASTIC PROJECTIONS OF THE DEBT-TO-GDP RATIO UNDER TEMPORARY SHOCKS

FIGURE VI.1B: STOCHASTIC PROJECTIONS OF THE DEBT-TO-GDP RATIO UNDER PERMANENT SHOCKS



Note: The graphs report the 10th, 20th, 40th, 50th, 60th, 80th and 90th percentile of distribution of the Debt-to-GDP ratio obtained by means of the stochastic simulation.
Source: MEF elaborations.

In the event of temporary shocks, the debt is distributed around a median value of approximately 125.8 percent of GDP in 2021. The uncertainty recorded on the results of 2021 is relatively limited, as shown by a difference of about 14.7 percentage points between the tenth and ninetieth percentiles of the resulting expected distribution of debt. The debt-to-GDP ratio shows a tendency to fall from 2018 for the first fifty percentiles, and from 2019 and 2020 for the sixtieth and the eightieth percentiles, respectively. Even for the most severe shocks (which are above the ninetieth percentile), the debt-to-GDP ratio shows a decreasing trend starting from 2020 after reaching, in 2019, a peak of around 135.1 percent.

The permanent shock determines a wider distribution of the values of the debt-to-GDP ratio around the central scenario, but assumes a similar dynamic to that obtained with temporary shocks for the first eighty percentiles. In the case of permanent shocks, the uncertainty recorded on the results of 2021 is greater, with a difference of about 16.9 percentage points between the tenth and ninetieth percentiles of the distribution.

VI.2 MEDIUM TERM PROJECTIONS

In this paragraph we extend the above analysis on sustainability and debt dynamics concentrating on a medium term (ten-year) horizon. As we argued in the May 2018 Report on Relevant Factors, 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 either not growing or decreasing. The level at which debt stabilizes in the medium term matters mostly in view of the risk of losing market access, which is however difficult to assess on an *a priori* base.

In the 2017 Debt Sustainability Monitor the Commission considers at "high risk" Member States whose debt-to-GDP ratios are projected to be above a certain threshold, set at 90 percent, over the next 10 years. However, empirical literature is inconclusive on the effect of specific debt levels on the economy. Furthermore, there is no evidence that countries risk losing market access for debt-to-GDP ratios above 90 percent.

Here we elaborate deterministic scenarios for simulating the projected evolution of the debt-to-GDP ratio over the medium term[19]. In this exercise, the projection horizon extends to 2029 and it incorporates, for the years 2018 to 2021, the macroeconomic outlook as well as the fiscal targets set in the 2018 Update to the Stability Programme policy scenario. 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 path derived on the basis of the T+10 production function extrapolation methodology agreed by the EPC Output Gap Working Group (OGWG). On the basis of such assumptions, real GDP growth is projected to be on average equal to 0.7 percent over the 2022-2029 period.

The cyclically-adjusted primary surplus is kept constant at the level estimated for 2021, equal to 2.2 percent of GDP. The debt-to-GDP ratio is extended over the medium term assuming, as a starting point, the composition and the maturity structure of the debt stock in the last year (2021) of the 2018 Update of the Stability Programme. The annual interest rates that, in addition to the primary surpluses, are needed to estimate the dynamics of the debt, are calculated using the Treasury SAPE model, which employs the current and forecasted government bond stock database.

It should be noted that the baseline scenario was constructed under prudential considerations. Starting from last May, yields on government bonds and volatility have experienced a sudden and significant rise. The baseline scenario incorporates recent market rates and uses them to project future yield levels out to 2029. This assumption is extremely prudential, as it implies a level of spread with respect to German bunds that is not in line with Italy's fundamentals.

On the basis of such assumptions, public debt as a ratio of GDP is projected to decrease steadily going from the level of 131.2 percent of 2017 to 126.8 percent of 2021 down to 120.1 percent in 2029 at the end of the forecast horizon.

In addition to this reference (or baseline) scenario, we show the results of a sensitivity analysis based on alternative deterministic scenarios. A number of assumptions that have a

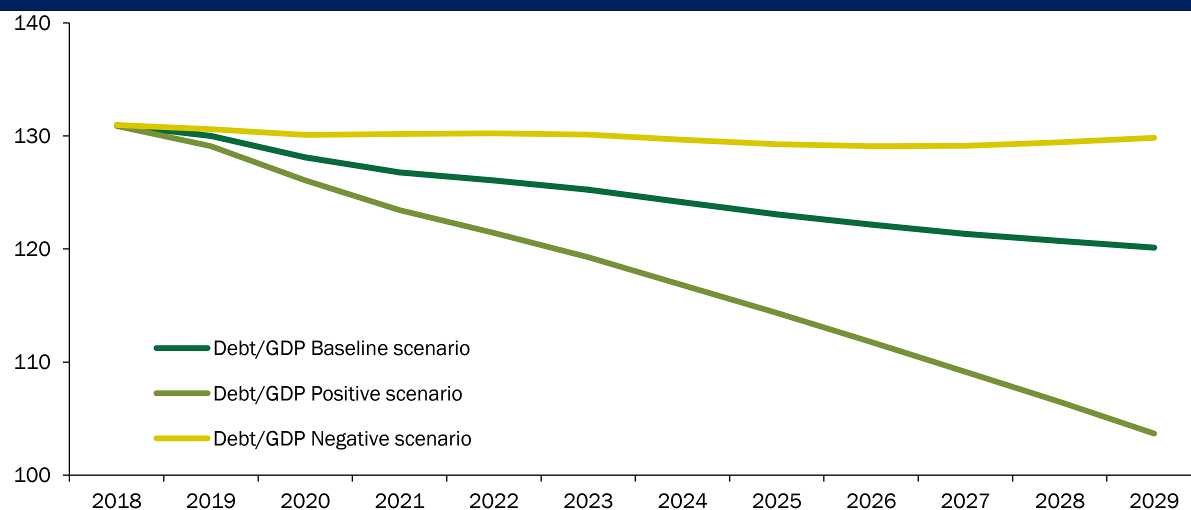
[19] A similar exercise was carried out by the Commission in its 2017 Debt Sustainability Monitor. The DSM deterministic debt-to-GDP projections are based on the Commission services 2018 Spring Forecasts up to 2019. From 2020 up to 2027, the no-policy change scenario is carried out assuming that the 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 percent 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 percent 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. In the so-called Commission baseline scenario, 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 percent over the period 2020-2027. 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 the age-related expenditures. On the basis of such assumptions, the Commission projects Italian public debt as a ratio of GDP to decrease slowly going from the level of 131.8 percent of 2017 to 129.7 percent of 2019 up to 126.2 percent in 2027 at the end of the forecasts horizon.

joint impact on GDP growth, yield curve and primary balances are made and allow for the extrapolation of the dynamics of the debt-to-GDP ratio out to 2029. Two scenarios are constructed, one incorporating a more benign interest rate path and, in the medium term, the favorable effects of reforms on growth, and the other reflecting the risk of a further tightening of financial conditions in the short term and sluggish productivity and labor market performance in the medium term.

The positive scenario assumes that from 2019 onwards the spread versus the ten year German bonds tightens permanently by 100 basis points as a result of a decrease in market volatility and a more balanced perception of risks associated to Italian public finances. Naturally, the spreads on the other maturities, shorter and longer than the 10-year maturity, are parameterized in line with the change observed on the 10-year maturity, taking into account the shape of the forward spread curve between Italian and German bonds. On the other hand, the negative scenario, in addition to a worsening of external conditions, foresees a further upward shift of the yield curve with respect to the baseline in the short term; interest rates on the 10-year maturity are assumed to increase by 100 basis points return to the baseline levels only from 2022[20].

Changes in the yield curves have an endogenous impact on nominal growth and therefore on the primary surplus. The impact of the short-term sensitivity assumptions is estimated with the Treasury macroeconomic model (ITEM). In the medium term, the underlying assumptions are more stylized and concern the behavior of total factor productivity and the structural unemployment rate (NAWRU).

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



Source: MEF simulations on 2019 DBP.

[20] It should be noted that, taking into account the significant increase in the volatility of security prices observed in recent months, the construction of alternative scenarios has opted for a certain level of asymmetry in the shift of the curve. For the Low-growth scenario, the hypothesis of a further permanent increase of rates compared to the reference scenario would not have seemed reasonable. The hypothesis of a contraction in yields of 100 basis points, however, supposed for the Target scenario, would only bring the curve closer to the levels prior to the recent rise. This kind of asymmetry was built also in the sensitiveness scenarios presented in the DEF 2018; at that stage further relevant reduction of interest rates were deemed not realistic; so the positive scenario incorporated a 50 basis point reduction of interest rates, whilst the pessimistic scenario envisaged a 100 basis points increase.

Assumptions and results are summarized in Table VI.1, with Figure VI.2 showing the Debt to GDP profile under the three different scenarios.

As observed in Figure VI.2, on the basis of the aforementioned hypotheses, the decreasing tendency of the Debt-to-GDP ratio is confirmed in the medium term for the baseline and the positive scenarios. In the negative scenario, the ratio is projected to decrease slightly in the first years of the forecast horizon and then stabilize.

TABLE VI.I: SENSITIVITY OF MACRO-FISCAL VARIABLES TO SHOCKS ON THE YIELD CURVE (PERCENTAGE VALUES)

		2018	2019	2020	2021	2029	average 2018-2029	average 2022-2029
Nominal GDP growth rate	Positive scenario	2,5	3,3	3,9	3,4		3,1	3,0
	Baseline scenario	2,5	3,1	3,5	3,1		2,8	2,7
	Negative scenario	2,5	2,9	3,0	2,7		2,6	2,5
Real GDP growth rate	Positive scenario	1,2	1,7	1,9	1,8		1,3	1,3
	Baseline scenario	1,2	1,5	1,6	1,4		1,0	0,7
	Negative scenario	1,2	1,2	1,2	1,1		0,8	0,6
Potential GDP growth rate	Positive scenario	0,7	0,9	1,1	1,1		1,0	1,0
	Baseline scenario	0,7	0,9	1,0	1,0		0,8	0,7
	Negative scenario	0,7	0,8	0,8	0,8		0,6	0,5
Output gap	Positive scenario	-1,9	-1,1	-0,4	0,3		-0,2	0,1
	Baseline scenario	-1,9	-1,2	-0,6	-0,2		-0,3	0,0
	Negative scenario	-1,9	-1,4	-1,1	-0,8		-0,6	-0,2
Net borrowing	Positive scenario	-1,8	-2,2	-1,5	-0,8		-0,8	-0,4
	Baseline scenario	-1,8	-2,4	-2,1	-1,8		-2,0	-1,9
	Negative scenario	-1,8	-2,6	-2,7	-2,6		-2,4	-2,4
Cyclically adjusted net borrowing	Positive scenario	-0,8	-1,6	-1,3	-0,9		-0,7	-0,5
	Baseline scenario	-0,8	-1,8	-1,8	-1,7		-1,8	-1,9
	Negative scenario	-0,8	-1,9	-2,1	-2,2		-2,1	-2,3
Primary surplus	Positive scenario	1,8	1,4	2,0	2,7		2,4	2,6
	Baseline scenario	1,8	1,3	1,7	2,1		2,0	2,2
	Negative scenario	1,8	1,1	1,2	1,5		1,7	1,9
Cyclically adjusted primary surplus	Positive scenario	2,8	2,0	2,2	2,5		2,5	2,5
	Baseline scenario	2,8	1,9	2,0	2,2		2,2	2,2
	Negative scenario	2,8	1,9	1,8	2,0		2,0	2,0
Implicit interest rate	Positive scenario	2,8	2,8	2,8	2,8		2,7	2,7
	Baseline scenario	2,8	2,9	3,0	3,2		3,3	3,4
	Negative scenario	2,8	2,9	3,1	3,3		3,3	3,4
Public debt	Positive scenario	130,9	129,1	126,1	123,4	103,7	117,7	112,9
	Baseline scenario	131,0	130,0	128,1	126,8	120,1	124,9	122,9
	Negative scenario	131,0	130,5	129,8	129,8	127,7	128,9	128,2

Source: MEF simulations on 2019 DBP.

VI.3 LONG-TERM FISCAL SUSTAINABILITY AND AGEING OF THE POPULATION

According to the current definition of the S1 sustainability indicator, the Italian public finances are considered at high risk over the medium term.

On the basis of the data underlying the 2018 Draft Budgetary Plan, the S1 indicator shows a required adjustment of the primary balance amounting to 7.5 percentage points of GDP, quite similar to the adjustment provided for the calculations made on the Commission's 2019 Autumn Forecasts (8.5 percentage points of GDP).

Compared with the values published in previous planning documents or Commission reports (see Table VI.II), the S1 indicator has recently deteriorated. This deterioration is not only due to changes in the government's budget objectives but it is also explained by: i) the change in 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 ratios increasingly challenging; ii) the change in the initial budgetary projections expressed in structural terms as a result of a shrinking output gap; iii) more recently, the worsening of medium and long-term macroeconomic projections for Italy in the 2018 Ageing Report.

With reference to the changing definition of the S1 indicator[21], it should be noted that the S1 indicator automatically worsens when the distance from the target year decreases. The changes in S1 definition introduced in 2012, by halving the length of the projection horizon from 2060 to 2030 and subsequently by reducing the distance to the target year, has raised the fiscal effort required to achieve the 60 percent of GDP debt threshold, making it particularly challenging for countries, like Italy, with high initial debt ratios.

TABLE VI.2: DEBT SUSTAINABILITY INDICATORS (p.p. of GDP)

	DPB 2019	2018 Autumn Forecasts	DSM 2017	DEF 2017	2015 Sustainability Report	DEF 2016
S1 Indicator	7,5	8,5	6,7	3,9	4,2	3,9
Of which:						
Initial Budgetary Position – Debt stabilizing factor	0,4	0,9	0,4	-2,8	-1,4	-2,8
Cost of Delay in the Adjustment	1,3	1,5	1,1	0,7	0,7	0,7
Debt requirement (convergence to 60% of GDP)	4,9	5,5	5,1	5,6	5,1	5,6
Ageing Costs	0,9	0,6	0,1	0,3	-0,2	0,3
S2 Indicator	1,6	2,8	0,6	-1,9	-0,9	-1,9
Of which:						
Initial Budgetary Position – Debt stabilizing factor	0,2	1,6	0,5	-2,0	-0,8	-2,0
Long term component	1,4	1,2	0,1	0,1	-0,1	0,1

Source: MEF computations on Italian official documents and on Commission reports.

21 For all the details see the Italian Ministry of Economy and Finance Report on the Relevant Factors Influencing Public Debt Development, May 2018, also available at: http://www.mef.gov.it/inevidenza/documenti/Italy_Report_Relevant_Factors_May_2018.pdf

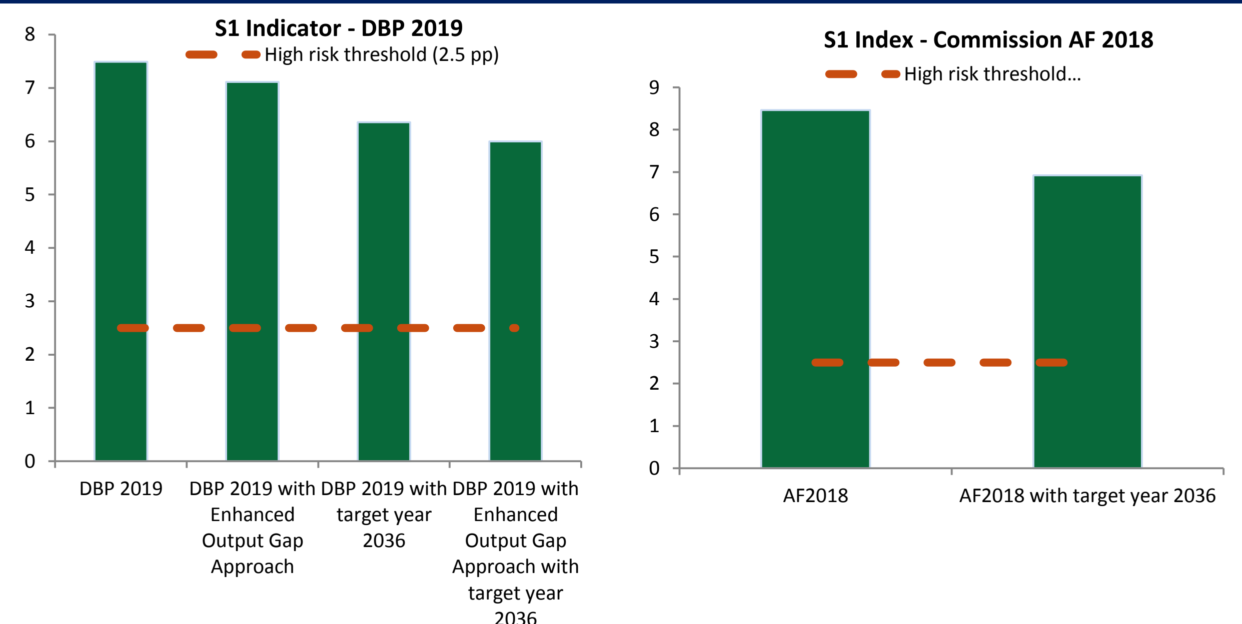
The S1 indicator is also highly dependent on the level of the cyclically-adjusted primary balance in the initial year. In this respect, a large share of the worsening of the S1 indicator is due to the no-policy change assumption carried out by Commission in the 2018 Autumn Forecasts which, as already mentioned, does not include the impact of the 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 reached a positive value of 0.3 percent , the cyclical component contributes to reduce the structural primary balance by 0.15 percent of GDP in the 2018 Autumn Forecasts.

In order to grasp the volatility of the S1 index, figure VI.3 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 Treasury's enhanced methodology presented in Chapter III, 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 ten years so as to convergence to the 60 percent of GDP in 2036 instead of 2033, as currently envisaged.

The sensitivity exercise on S1 has been carried out on the basis of the 2019 DBP medium term scenario as well as on the basis of the 2018 Commission services Autumn forecasts. As it is possible to grasp from Figure VI.3, lengthening the target year for the S1 indicator to 2036 toghether with a more balanced assessment of the cyclical condition in Italy, would sizebly reduce the fiscal adjustment required to converge to the debt threshold of 60 percent of GDP.

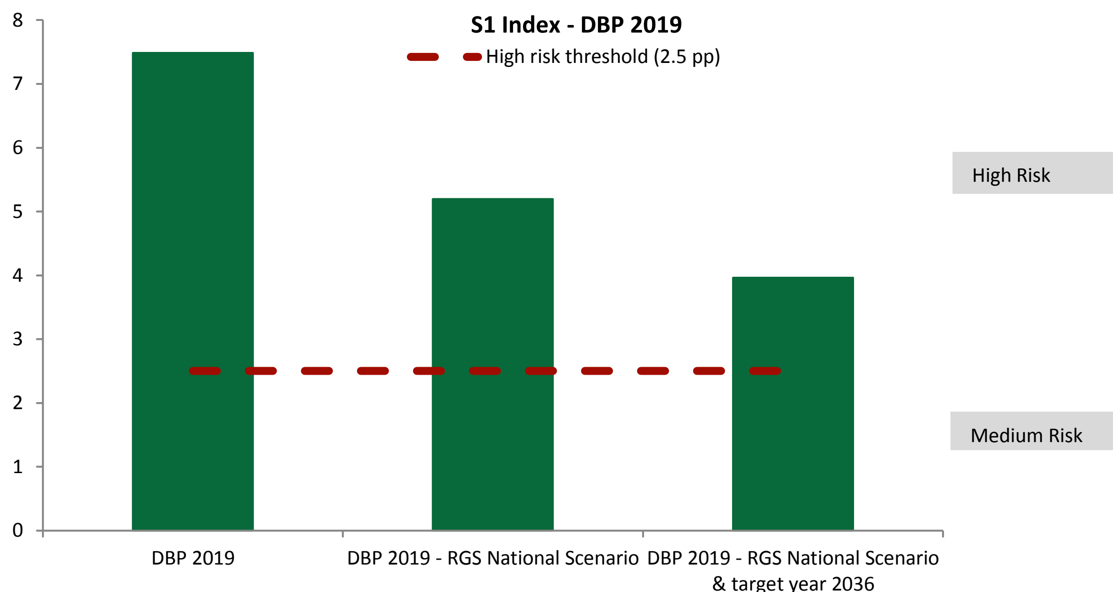
FIGURE VI.3: SENSITIVITY OF THE S1 INDEX TO CHANGES IN THE INITIAL CYCLICAL CONDITIONS AND TO CHANGES IN THE TARGET YEAR



Source: MEF elaborations on 2019 DBP and 2018 Commission services Autumn 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[22], significantly lowers Italy's real GDP growth projections compared to the 2015 projections. Due to a reduction in the net migration flow, coupled with muted TFP prospects, over the period 2016-2070 real GDP growth for Italy would average 0.7 percent vis-à-vis 1.4 percent in the 2015 Ageing Report. In particular, average real GDP growth over the next 12 years is projected to be as low as 0.3 percent .

FIGURE VI.4: SENSITIVITY OF THE S1 INDICATOR TO CHANGES IN MEDIUM TERM GROWTH ASSUMPTIONS AND IN THE TARGET YEAR



Source: MEF elaborations on 2019 DBP.

In order to assess the reaction of S1 to changes in medium term potential output growth scenarios, the indicator has been recalculated under the alternative growth assumptions of the so-called RGS long term national scenario[23], see Figure VI.4. Under these assumptions, the indicator reduces from 7.5 to 5.2 and it further decreases to 4 percent of GDP when the target year is moved from 2033 to 2036, making the fiscal adjustment more feasible.

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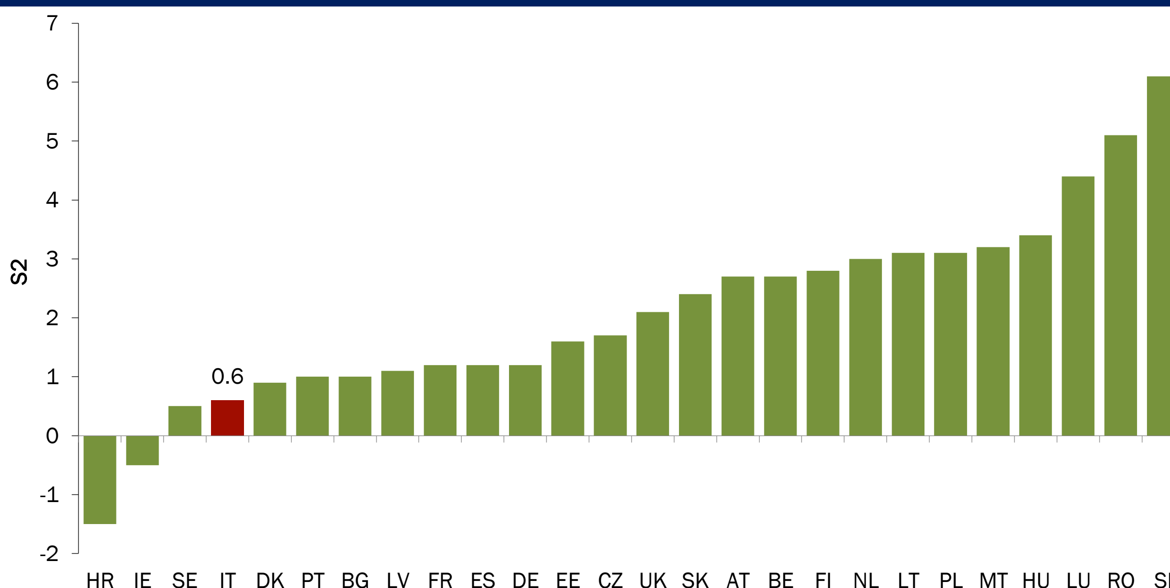
[22] See the Report https://ec.europa.eu/info/sites/info/files/economy-finance/ip065_en.pdf

[23] 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 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.

On the basis of the above considerations, the Government believes that the S1 indicator can not be considered a fully reliable index to assess whether a country is experiencing sustainability risks.

Turning to the indicator of long-term sustainability, S2, the Commission confirms that Italy's debt is one of the more sustainable over 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 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 EU countries (Figure VI.5).

FIGURE VI.5: LONG-TERM FISCAL SUSTAINABILITY (S2 indicator)



Source: European Commission, 2017 Debt Sustainability Monitor.

Liabilities emerging from ageing of the 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 VI.3, the 2018 Ageing Report projects for Italy a reduction of 1.7 percent of GDP in pension expenditure and a slight increase of 0.7 percent of GDP in health-care expenditure over the period 2016-2070. These changes are, respectively, well below and in line with the average for the EU and Euro area.

TABLE VI.3: 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.

VII. PUBLIC DEBT STRUCTURE, CONTINGENT LIABILITIES AND FINANCIAL RESILIENCE

VII.1 PUBLIC DEBT STRUCTURE

General government debt consists primarily (84 percent) of central-government securities. At the end of October 2018 the stock of government securities is 4 percent higher than that of the end of 2017. The composition of debt, on the other side, continues to deliver high resilience to financial risks (such as refinancing, interest, inflation and exchange rate risks).

Indeed considering that at the end of October the stock of government securities reached 1,982,558.65 euros, the share of Treasury Bills (BOTs)[24] remained fairly stable from 5.59 percent at the end of 2017 to 5.69 percent at the end of October 2018. The CTZs' share[25] increased only slightly, moving from 2.13 percent to 2.81 percent over the same period, while the stock of fixed-rate BTPs[26] moved a bit lower from 71.78 to 71.08 percent. If we focus only on long dated BTPs with a residual maturity equal or longer than 10 years, its share remained at around 24 percent of the total stock of fixed-rate BTPs.

Despite the turbulence that characterized the market for Italian government bonds since May, the share of total debt issuance of bonds with a maturity equal or longer than 10 years during the first 10 months of the current year was around 19.8 percent vis-à-vis a share of 21.9 percent in 2017.

The results in terms of exposure to refinancing risk confirm that no significant change has occurred: the average life of the total stock of government securities is now – end of October - 6,78 years compared to 6.9 years in 2017, 6,91 years in March and 6,84 years in October 2017. At the end of October the share of securities[27] maturing in the next year moved to 16.54 percent to 15.09 percent as of March, while the share of paper coming due in the next 5 years reached 46.23 percent while it was 43.99 as of March.

The same applies to exposure to interest rate risk and inflation: in 2017 the quota of CCTeus (floaters with a maturity of 7 years linked to 6-month Euribor rate) was 6.97 percent which compares to 7.03 as of October 2018, whereas that of BTP€I and BTP Italia (real bonds linked, respectively, to European and Italian inflation) went from 11.18 at the end of 2017 to 11.28 percent as of October. Accordingly, the total share of floating debt (CCTeus, BTP Italia and BTP€i) was pretty much stable at around 18.31 percent if compared with the end of 2017 (18.15 percent).

Looking more specifically at the interest rate risk, the *Average Refixing Period (ARP)*[28] declined only marginally from 6.25 as of the end of 2017 to 6.11 years as of September,

[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.
[27] These data include also Postal Bonds.
[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 nominal fixed-rate securities, the indicator is based on the residual life of each security, whereas for variable-rate securities and linkers , the indicator is based on the time to

while the duration of total stock of government securities also went slightly down, moving from 6.01 as of end 2017 to 5.75 years, where however part of this reduction is due to the increase of market interest rates[29].

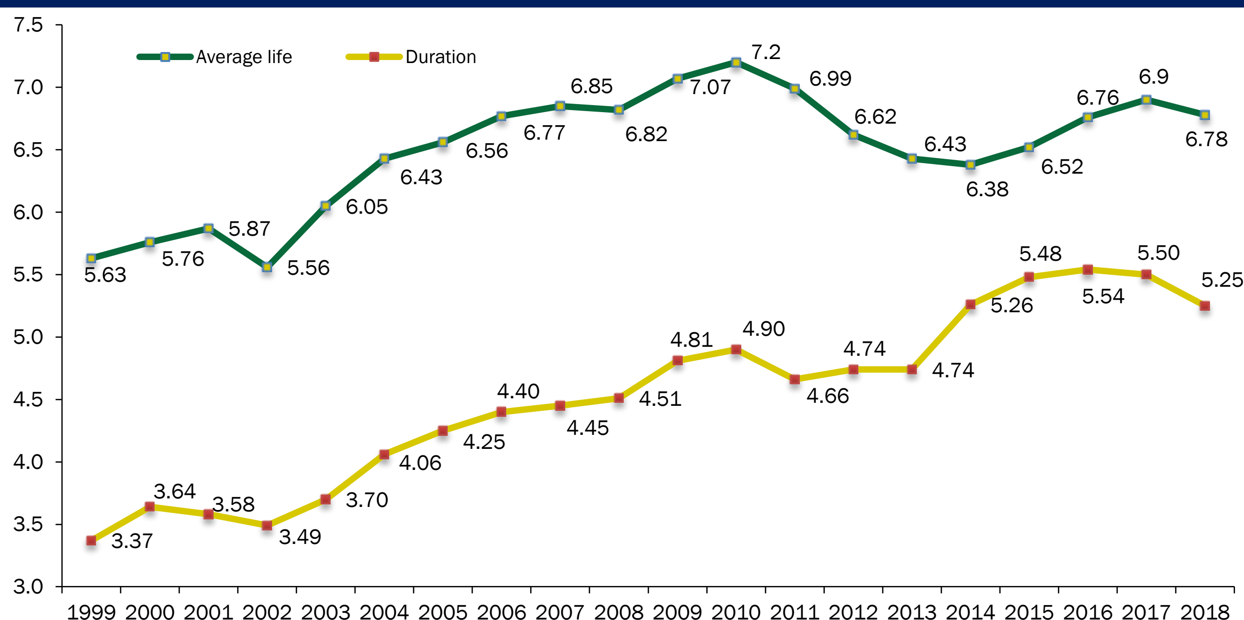
The evolution of the sensitivity of total debt interest burden to market shocks provides another way to look at how the exposure to interest rate risk has been managed over the year.

A permanent shock of 100 basis points on the whole yield curve would impact the interest debt burden for just 0.11 percent of GDP in the first year, 0.27 points in the second year, 0.39 points in the third year, these numbers being substantially in line with those of April published in the DEF 2018.

Finally, the exposure to exchange rate risk in 2018 remained negligible compared to 2017: at the end of October the share of debt issued in foreign currency unhedged[30] was 0.11 percent, unchanged with respect to the end of 2017.

Since May interest rates on Italian debt increased significantly. On average comparing the levels as of mid May and those as of end of October the shift upward has been of 160 basis points while the spread over German government bonds moved up from 130 basis points to around 300 basis points on the 10 year maturity.

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



Source: MEF

elapse until the indexing of the next coupon. Each security is included in the weighted calculation for the nominal value outstanding. Data also include Postal Bonds.

[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.

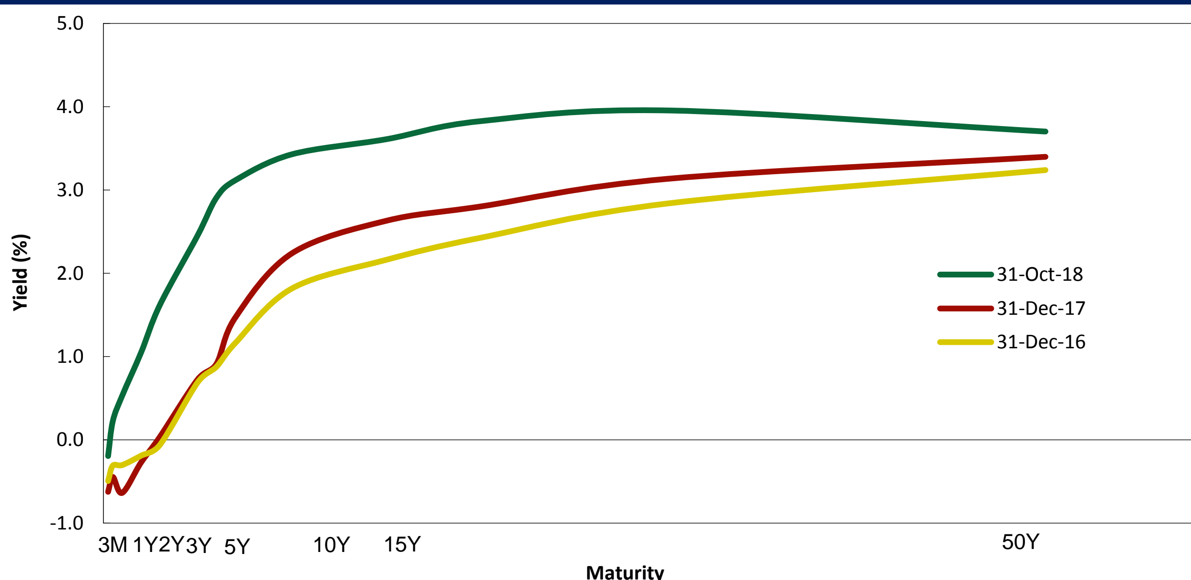
The shape of the yield curve has experienced a relative increase of the slope in the 1-10 year segment since the end 2017 (about 45 basis points). The front end of the curve, initially impacted by the increased volatility following the turmoil started in mid-May, was subsequently anchored with a substantial general re-steepening. Indeed, despite the general upward shift of the yield curve, at the end of October the 1-10 year slope was in line with the year-to-date average.

Conversely, the slope of the 10-30 year segment decreased significantly (from 120 to 54 basis points), showing a persistent interest from investors in long-term Italian government securities, attributable to the liquidity of the secondary market compared to other sovereign bond markets.

Despite periods of rather high volatility, the average cost at issuance at the end of October 2018 (January-October) did not exceed 1.0 percent, a level that is still near the record low registered in the last few years.

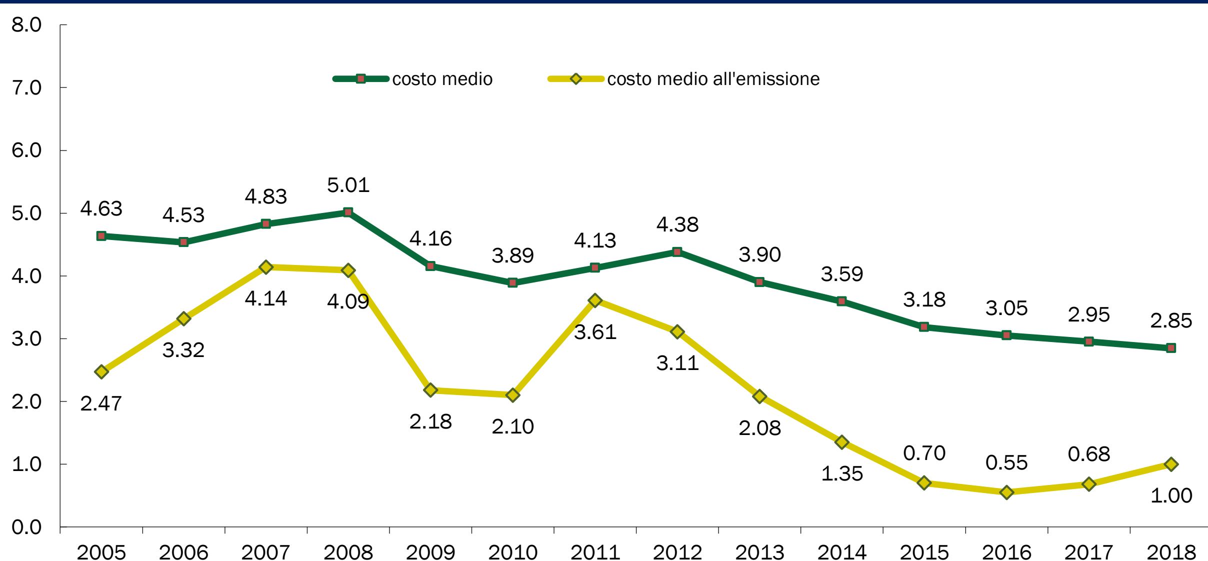
By remaining anchored to a debt management policy focused on keeping under control and further improve resilience to market risks, Italy continued to achieve a reduction of the interest burden, that has been declining since 2012.

FIGURE VII.2 – EVOLUTION OF ITALIAN DEBT YIELD CURVE



Source: MEF.

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



Source: MEF.

Indeed the average cost level on General Government Debt is estimated to reach 2.85 percent in 2018, which still represents a reduction of around 0.11 percent vis-à-vis the 2017 level (2.95 percent). If the issuance activity in 2018 had been skewed towards shorter maturities, the marginal cost at issuance would have been lower, also driving down the average cost. However, this policy would have left the debt more exposed to market risks in the future.

VII.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[31], the share moved further down by approximately 0.2 percentage points. Accordingly, given the constant reduction pattern, possible risks of roll-over may only stem from the initial share.

[31] Supplemento al Bollettino Statistico – Finanza pubblica, fabbisogno e debito del 15 Ottobre 2018. Tavola 8.

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 the 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[32] reports for Italy a GFN for 2018 of 22.2 percent of GDP, in line with the 21.1 G7 average.

As shown in the previous section, Italy's public debt presents a high average term to maturity (average life) of 6.8 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 19.3 percent of GDP, only marginally higher than the average for G7 countries (Table VII.1).

TABLE VII.1: STRUCTURAL INDICATORS FOR THE DEBT IN 2018

Country	Average term to maturity, 2018	Debt-to-average maturity, 2018
AT	8.3	8.9
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*	**6.8**	**19.3**
NL	6.9	7.7
PT	6.2	19.4
SI	8.5	8.2
SW	4.7	8.1
UK	14.9	5.9
USA	5.8	18.3
JPN	7.7	31.1
AUS	7.4	5.5
CAN	5.4	16.1
G-7	6.9	17.9
G20 ADV.	6.9	17.1

Source: IMF Fiscal monitor – October 2018.
(*) Figures provided by national authorities.

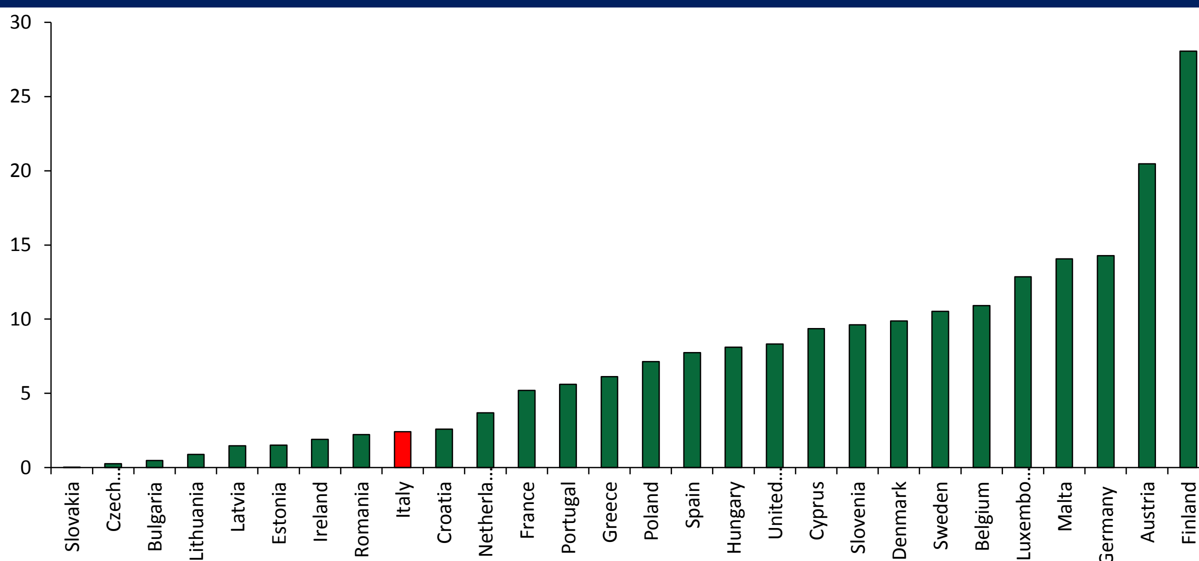
[32] IMF, 2018, Fiscal Monitor: Managing Public Wealth, October 2018, available at: https://www.imf.org/en/Publications/FM/Issues/2018/10/04/fiscal-monitor-october-2018

VII.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 guarantees on liabilities 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 th pick of 5.3 percent of 2012). More recently, the government has been issuing guarantees on senior tranches of securitizations of NPLs (GACS). The amounts involved do not change the overall picture, as they are small as a share of GDP.

FIGURE VII.1 - TOTAL STOCK OF GOVERNMENT GUARANTEES IN 2016 (% of GDP)

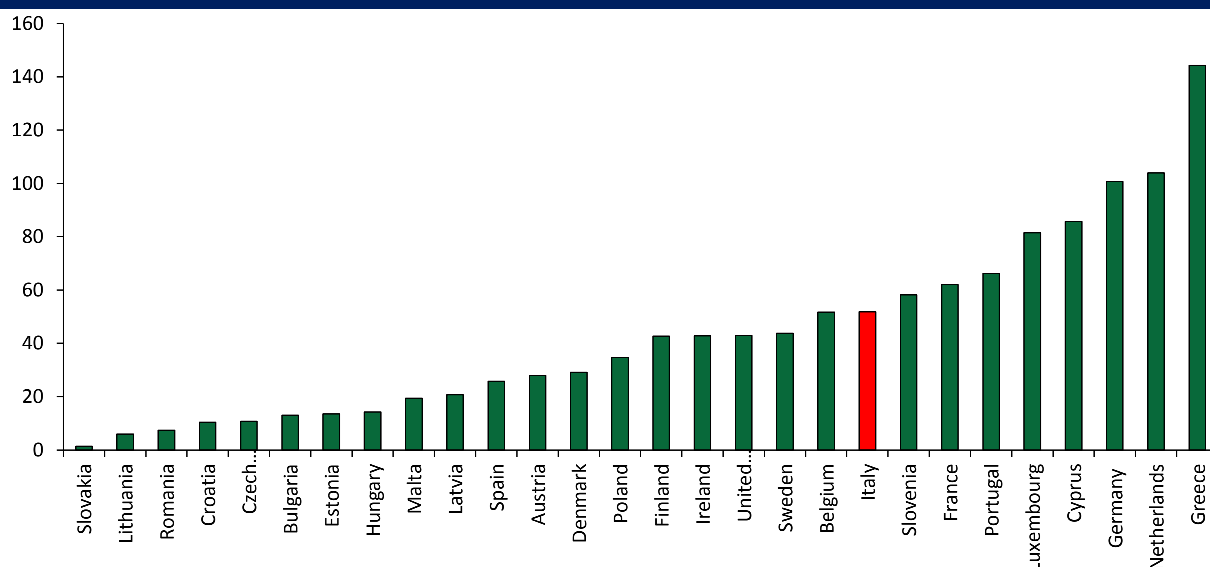


Source: Release No. 19/2018.

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 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 or by other kinds of private or public entities; iii) financial institutions report high amounts of debt liabilities, however they also have, at the same time, significant level of assets which are not captured in this data.

FIGURE VII.2 - TOTAL LIABILITIES OF GOVERNMENT CONTROLLED ENTTIES IN 2016 (% of GDP)



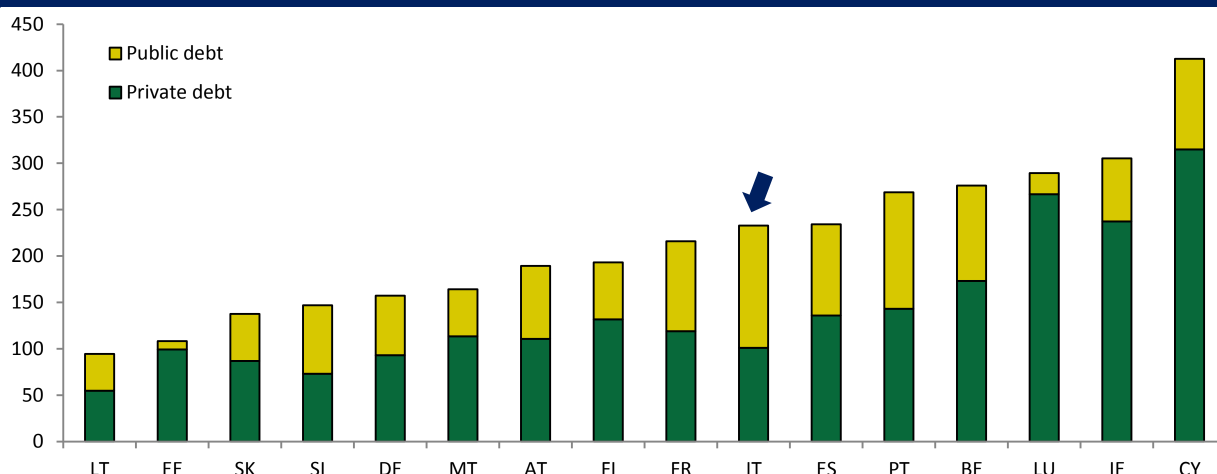
Source: Eurostat, Release No. 19/2018. For Czech Republic, Germany, France and Austria data of 2015; for Cyprus data of 2017.

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 the highest stock of NPLs, the majority of these loans refer to loans of financial defeasance structures, which are classified in the general government sector.

VII.4 PRIVATE SECTOR DEBT

Firms' and households' financial conditions continued to improve in 2017. The latest data by Eurostat suggest that the private debt-to-GDP ratio (for both households and non-financial companies) decreased by 2.3 percentage points in 2017 compared with the previous year. As a result, the total debt-to-GDP ratio (public and private) was reduced by 1.1 percentage points, as the debt of Italian households is still one of the lowest in the euro area. In 2017, household debt amounted to approximately 41 percent of GDP, 0.2 percentage points below the level of 2016 and lower than the euro area average (which is above 53 percent of GDP). With regard to non-financial corporations (NFCs), the ratio of firms' financial debt-to-GDP ratio amounted to 60.3 percent in 2017 (-0.8 percent points than in 2015), well below the euro area average (around 77 percent of GDP).

FIGURE VII.6 - PUBLIC AND PRIVATE DEBT DECOMPOSITION (% of GDP, 2017)

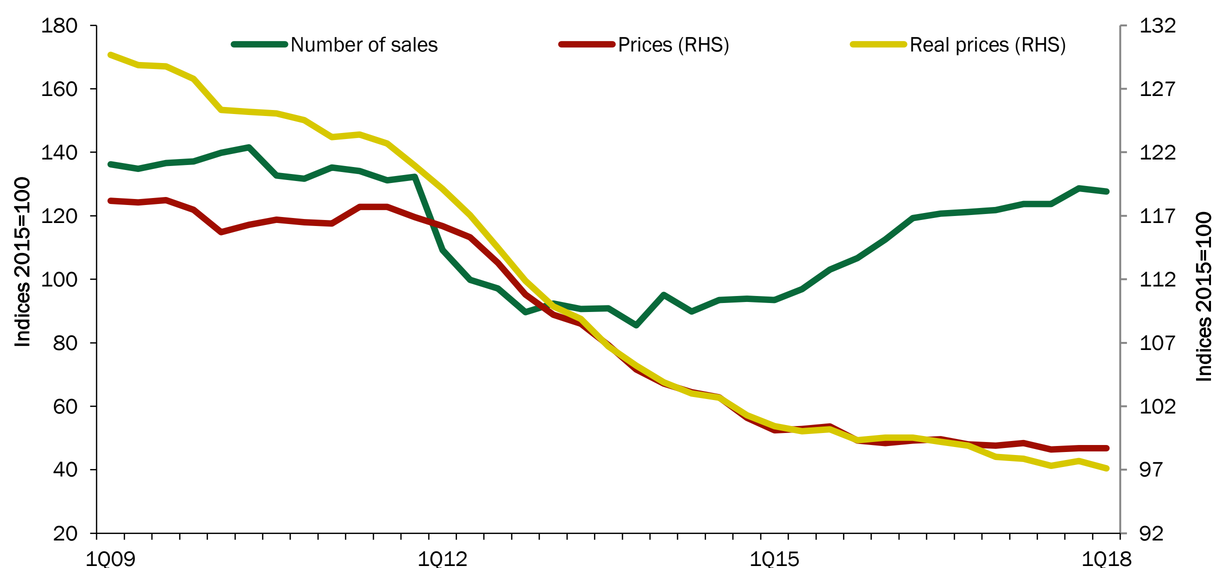


Source: Eurostat.

VII.5 PROPERTY PRICES

The property market began to recover in 2015 in terms of transaction volumes, and prices have nearly stabilized nominal terms. However, valuations remain low and are still declining in real terms. The Italian Housing Market Survey, conducted in July, suggests that most real-estate agents judged demand conditions to be stable. The market thus looks resilient, having already undergone a large price adjustment and regained good affordability levels.

FIGURE VII.7 RESIDENTIAL PROPERTY

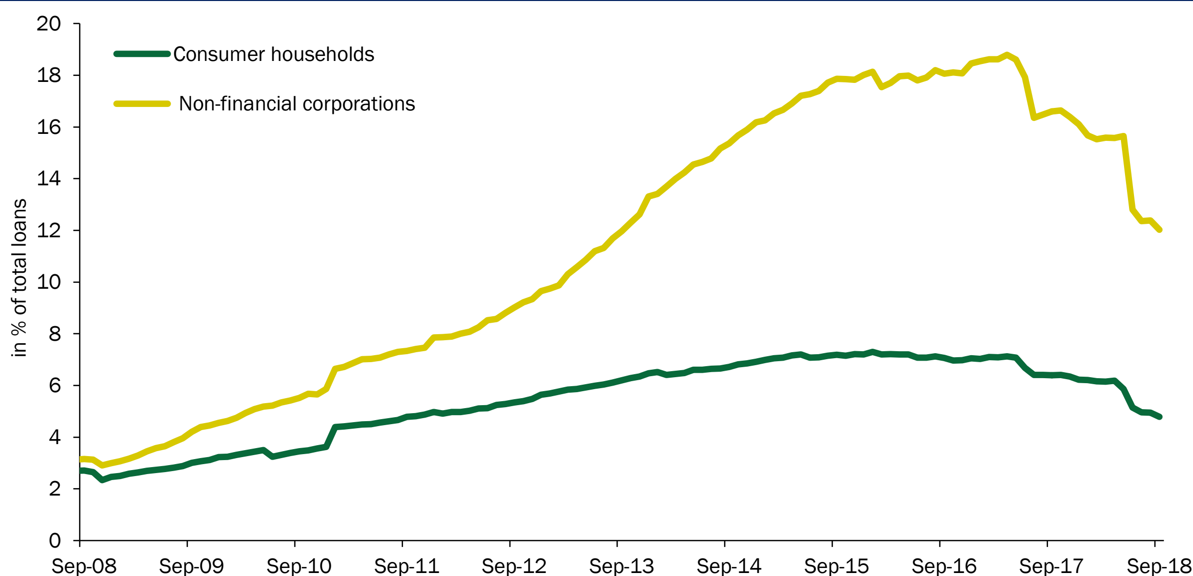


Source: Bank of Italy.

VII.6 BANKS' CAPITAL RATIOS AND NPLS

Italian banks' capital continues to grow. Latest data from Bank of Italy[33] show that, in June, the common equity tier 1 (CET1) of significant banks was equal to 12.7 percent of risk-weighted assets. For the banking groups classified as systemically relevant, in the second quarter of 2018 the ratio of NPLs to total outstanding loans continued to diminish, both gross and net of loan loss provisions (reaching 9.7 and 4.7 percent, respectively, from 10.8 and 5.3 percent in the first three months of 2018). This reduction is largely attributable to further sales of bad loans, which were already heavily written down. As a result of these sales, the coverage ratio for non-performing loans of significant banking groups fell by 1.0 percentage points, to 54.4 percent.

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

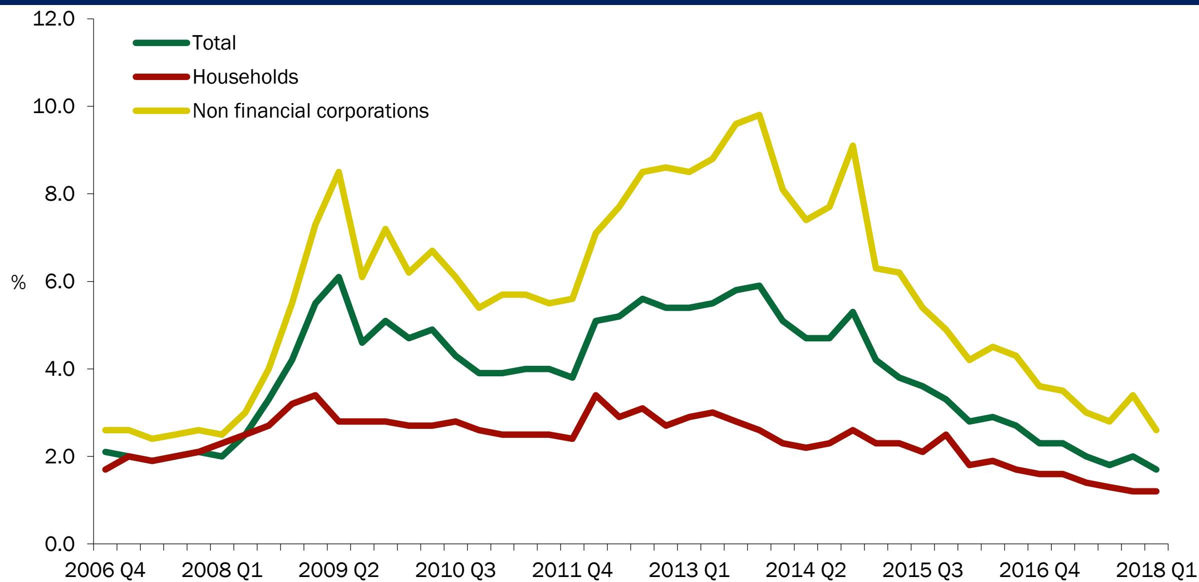


Source: Bank of Italy.

The rate of deterioration in credit quality is back to pre-crisis levels. In the second quarter of 2018, the ratio of new non-performing loans to outstanding loans fell to 1.5 percent on a seasonally adjusted annualized basis (from 1.7 percent in the previous quarter). The ratio was unchanged for loans to households (1.2 percent) and declined for those to firms, to 2.2 from 2.6 percent.

[33] See: Bank of Italy, "Banks and Money: national data – September 2018", November 2018 and Bank of Italy, "Economic Bullettin No. 4 2018", October 2018.

FIGURE VII.9 NEW NON-PERFORMING LOAN RATE



Source: Bank of Italy.

REPVBBLICA ITALIANA