

Relevant Factors Influencing Public Debt Developments in Italy

April 2021



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EXECUTIVE SUMMARY

- At the request of the European Commission, and in accordance with Article 126(3) of the TFEU, this report discusses factors that the Italian government deems “relevant in order to comprehensively assess in qualitative terms the excess (of the public debt ratio) over the reference value” in 2020. The report also summarizes Italy’s Stability Programme for 2021-2024 and reiterates the government’s commitment to a long-term debt-reduction program.
- The Commission’s request is motivated by the sharp increase in the deficit and debt ratios that was recorded in 2020. Italy’s general government budget deficit rose to 9.5 percent of GDP, from 1.6 percent in 2019; gross general government debt reached 155.8 percent of GDP, from 134.6 percent in 2019.
- The sharp worsening of the deficit and debt ratios in 2020 was due to the recession caused by the Covid-19 pandemic and to the substantial economic relief packages that were enacted in response to the crisis. Real GDP shrunk by 8.9 percent, while the *ex ante* size of relief packages was equivalent to 6.5 percent of GDP. The government also introduced a moratorium on bank loans and a dedicated program of State guarantees that reached 7.1 percent of GDP at year-end.
- The relief packages that were enacted in 2020 were necessary to support the economy and to minimize the impact of the crisis on workers and firms, especially in sectors that were directly affected by social distancing measures and outright closures. Without these actions, the drop in GDP and employment would have been far larger and would have threatened socioeconomic and financial stability.
- Covid-19 vaccinations began at the turn of the year. Even so, in order to counter a third wave of infections it was necessary to implement new relief measures in early 2021. A package worth 32 billion was enacted in March and a further one worth up to 40 billion will be finalized in early May. Taken together, the two interventions are worth 4.1 percent of GDP.
- The number of doses of Covid-19 vaccines administered is close to 19 million. More than 5 million people have received two doses, on a population of 59.6 million. Still, the government intends to immunize 80 percent of the population by early autumn. If the target is achieved, social distancing measures will be relaxed and economic conditions will gradually return towards pre-crisis levels.
- Based on this key assumption and on the impulse to be provided by the Recovery and Resilience Plan (RRP), in the new Stability Program the government projects real GDP growth of 4.5 percent this year, 4.8 percent in 2022, 2.6 percent in 2023 and 1.8 percent in 2024.
- The budget deficit is projected to rise to 11.8 percent of GDP this year, before gradually falling to 3.4 percent of GDP in 2024 and 2.3 percent of GDP in 2026. Government debt will rise to 159.8 percent of GDP and then decline to 152.7 percent in 2024 and 149.1 percent in 2026, the final year of the RRP.

- For the first time since 2009, the primary budget balance in 2020 turned into a deficit of 6.0 percent of GDP, from a 1.8 percent of GDP surplus in 2019. The primary deficit is expected to widen to 8.5 percent-of-GDP this year and then gradually improve from 2022 onwards, turning into a surplus by 2026.
- The policy strategy of the government is to steadfastly support the economy and maintain social cohesion until the pandemic crisis is resolved and to ensure that viable firms will not be jeopardized due to liquidity or capital shortages.
- In addition, the government is launching a major revitalization and transformation plan thanks to the resources of Next Generation EU and to additional national funds. Italy's RRP will utilize the maximum amount of available resources from the Recovery and Resilience Facility (RRF), 191.5 billion, plus national funds worth 30.6 billion and 13 billion from REACT-EU, for a total envelope of 235 billion.
- The RRP features structural reforms in key areas highlighted by Country Specific Recommendations (CSRs) such as the public administration, the justice system, competition and taxation. In addition, regulations concerning public works will be streamlined in order to raise efficiency without prejudice to anti-corruption goals, and multiple sectoral reforms will be implemented jointly with RRP investment.
- Consistent with the policy scenario of the Stability Programme, Italy's potential GDP growth rate will rise to 1.4 percent by 2024, from 0.6 percent in the latest pre-crisis assessment. The potential growth rate projected for 2024 is the result of a 0.5 percentage point contribution from total factor productivity, 0.25 percentage points from capital deepening and 0.65 points from the labour input. Reforms envisaged in the RRP could raise potential growth by a further 0.3 percentage points annually in the medium and long term.
- The RRP and the budgetary plan will strongly improve the sustainability of Italy's public finances by moving the economy onto a growth path that will be sustainable not only from a financial standpoint, but also environmentally and socially.
- The debt sustainability analysis presented in the Stability Programme and further developed in this document shows that, if the 2024 deficit target is achieved and the budget balance improves by a further 0.5 percent of GDP per annum until 2026 and is subsequently held constant, the debt-to-GDP ratio will fall from this year's peak of 159.8 percent to 135.5 percent in 2032. Furthermore, if after 2026 the government were to pursue a deficit-reduction path consistent with the existing rules of the preventive arm of the Stability and Growth Pact, the debt ratio would fall to 124.5 percent by 2032.
- Although the gross debt ratio projected for 2032 would still be high compared to the reference value of 60 percent, in all likelihood the stock of debt held by the market will be significantly lower than the values mentioned above. When assessing the overall creditworthiness of the Republic of Italy one should also consider the substantial assets held by the general government. Moreover, although an unprecedented amount of State guarantees has been issued since the start of the Covid-19 crisis, the stock of contingent liabilities remains relatively low compared to other large EU Member States.

I. ITALY'S ECONOMIC AND FISCAL PERFORMANCE IN 2020

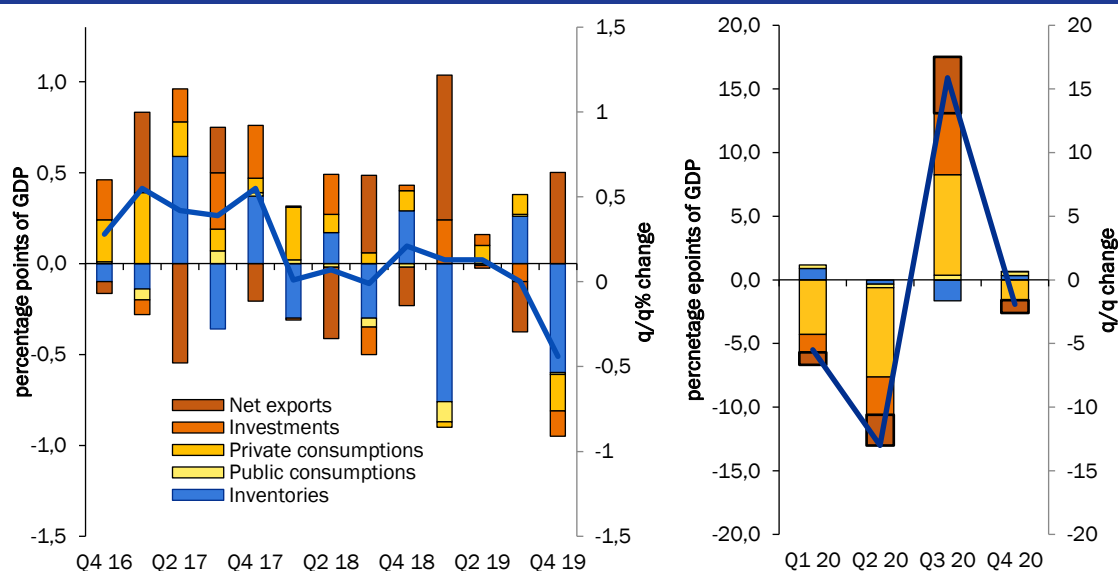
I.1 CYCLICAL DEVELOPMENTS

Last year, the Covid-19 pandemic led to an unprecedented contraction in economic activity in peacetime, with GDP falling by 8.9 percent in real terms. After the sharp collapse in the first half of last year (-9.3 percent compared to the previous six months), thanks to an easing of restrictive measures, GDP recorded a marked rebound in the third quarter, 15.9 percent q/q. However, as the second wave of infection materialized, economic activity suffered a new setback, contracting by 1.9 percent q/q in the last quarter of the year.

Even so, thanks to a more selective approach to the containment of the epidemic, economic activity became less strictly correlated with the evolution of Covid-19 infections. In fact, if one compares the epidemic assumptions that were made in the Draft Budgetary Plan with the actual outcome, infections have exceeded by far the baseline assumption, whereas the performance of the economy has been less distant from the forecast made in the early autumn.

The drop in GDP was driven by the collapse in domestic final demand, which subtracted 7.8 percentage points from growth, while the change in inventories and net exports subtracted 0.3 percentage points and 0.8 percentage points, respectively.

FIGURE I.1: CONTRIBUTIONS TO GDP GROWTH (p.p. of GDP, left scale; percent change q/q, right scale)



Source: ISTAT

The drop in household consumption was deeper than that of GDP. Despite numerous fiscal interventions that were carried out over the course of the year to support households (ranging from monetary transfers to tax deferrals), real disposable income decreased by -2.6 percent and the propensity to save rose to 15.8 percent on average last year. While the balance sheet of households remains solid, it has

deteriorated in the fourth quarter of 2020: household debt as a percentage of disposable income rose, reaching 64.7 percent, a level still below the euro-area average (97.6 percent). As a share of GDP, household debt stands at 45.2 percent (62.7 percent in the euro area).

Investment declined significantly (-9.1 percent), albeit less than expected. In Q4, notwithstanding the reduction in GDP, gross fixed investment recorded a slight increase (0.2 percent q/q). The investment rate (i.e. the ratio of gross fixed capital formation to value added) gradually increased during 2020, from 20.5 percent in Q1 to 21.6 percent in Q4.

The debt of non-financial corporations increased in the fourth quarter of 2020, reaching 76.9 percent of GDP, compared with 115.5 percent for the euro area. There has also been an increase in the liquidity held by firms in their deposit and current accounts.

As for credit quality, the latest data show that the reduction of NPLs on the part of banks continued last year, with a 29.6 percent decrease in the stock of bad loans compared to 2019 (when they fell by 28.8 percent). The potential impact of the crisis has been mitigated by the government's interventions both in the field of moratoriums and public guarantees on new loans, as well as in support of the income of households and businesses.

On the domestic demand side, the only component recording an expansion last year was public consumption (3.0 percent), driven by the fiscal policy measures adopted to support the economy.

As for foreign trade, the volume of imports fell sharply due to the drop in domestic demand, but slightly less than that of exports (-12.6 percent and -13.8 percent respectively). The decrease in trade flows was due also to the marked contraction recorded by the services component.

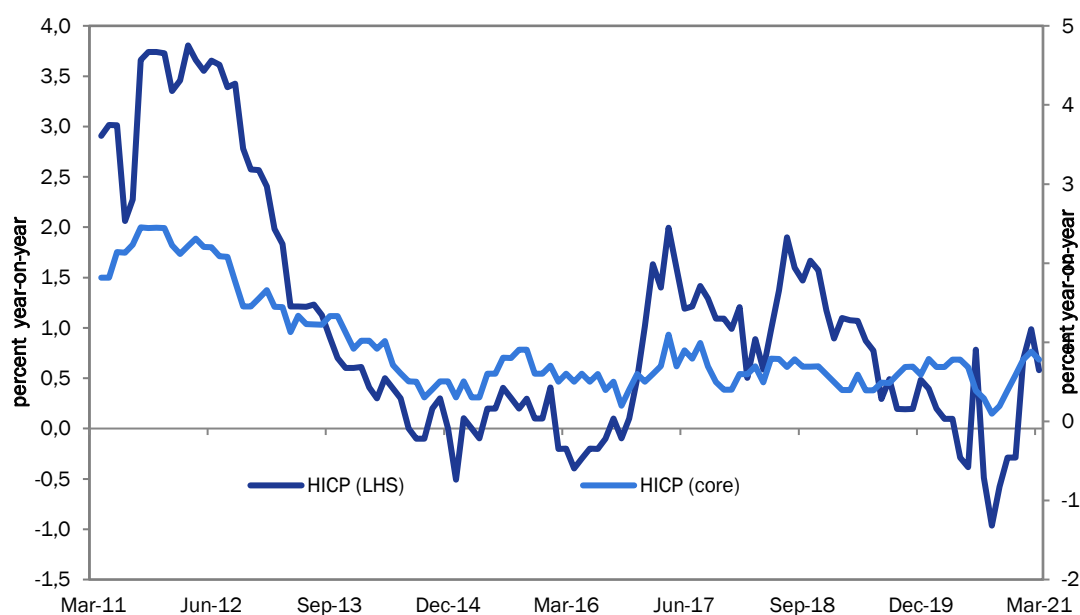
The sharp fall in energy prices in the first part of last year led the prices of imported goods and services to collapse, compared with only a modest contraction in export prices. The current account surplus of the balance of payments thus increased to 3.6 percent as a share of GDP (from 3.0 percent of GDP in 2019). At the end of 2020, Italy's net international investment position was positive by € 30.4 billion (1.8 percent of GDP), up from the € 15.2 billion recorded at the end of September, entirely due to the higher current account surplus.

On the supply side, industrial output dropped by 10.3 percent in 2020. The textiles, clothing, leather and footwear sectors were particularly affected by the crisis. The construction sector showed a "V" shaped dynamic: after a heavy contraction in the second quarter (-21.6 percent q/q), it bounced back to pre-crisis levels already in the third quarter. Nonetheless, the reduction in annual output was significant (-6.3 percent). The services sector was severely affected by the crisis, recording a loss in value added of -8.1 percent. Entertainment, commerce, catering and accommodation were severely impacted by the measures to contain the contagion and remained way below their pre-crisis levels through to the final months of the year.

I.2 TRENDS IN INFLATION AND GDP DEFLATOR

The average inflation rate in 2020 was -0.2 percent (from 0.6 percent in 2019), dragged down by a drop in energy prices that was not completely offset by the rise in food prices. Core inflation was almost stable compared to 2019, at 0.7 percent (from 0.6 percent).

FIGURE I.2: CONSUMER PRICES (percent changes y/y)



Source: ISTAT

The reduction in energy prices led to a significant contraction of the import deflator (-4.1 percent). Consequently, even in the face of negative consumer price dynamic, growth in the GDP deflator ticked higher, to 1.2 percent from 0.8 percent in 2019. Sluggish nominal growth remains a key hindrance to the reduction in the public debt ratio.

I.3 FISCAL PERFORMANCE AND ITS KEY DRIVERS

The general government budget deficit in 2020 rose to 9.5 percent of GDP, from 1.6 percent in 2019, which was the lowest recorded in the last thirteen years. The sharp deterioration compared to 2019 was the result of both the negative cyclical component resulting from the exceptional fall in GDP and the discretionary measures that were taken to mitigate the economic and social impact of the pandemic crisis.

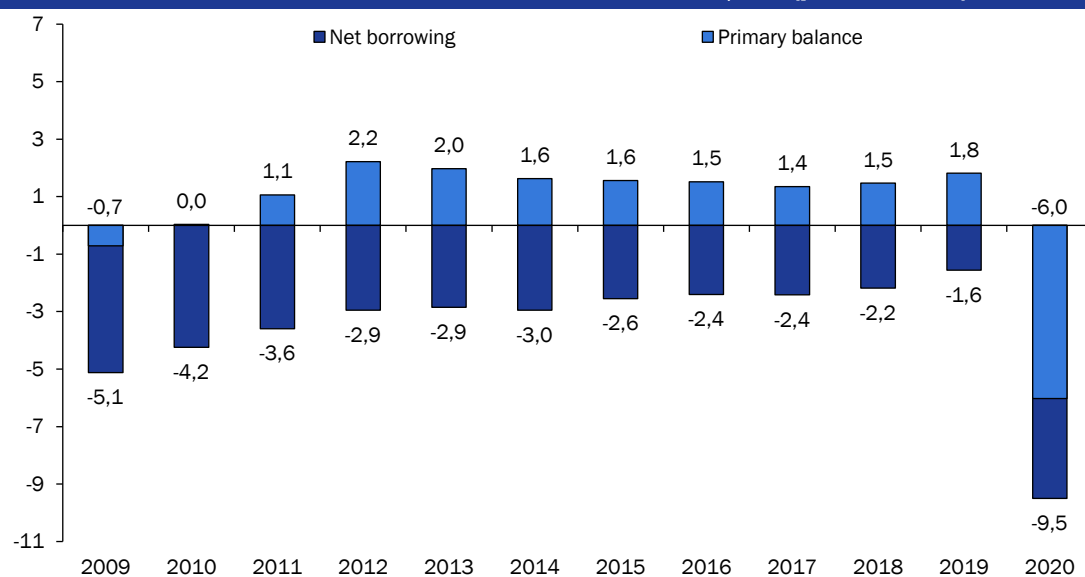
The 2020 outturn was better than the original target, which was originally set at 10.8 percent of GDP in the Update of the Stability Programme 2020 approved by Italian Parliament at the beginning of October 2020 (2020 Update), and subsequently revised to 10.5 percent in the 2021 Draft Budgetary Plan (DBP) thanks to a downward revision of public expenditure projections. The result is also below the forecast based on the

scenario inclusive of the new policies of the 2020 Stability Programme, which planned a deficit of 10.4 percent of GDP for 2020.¹

Expenditure for intermediate consumption, other current expenditures and public-sector wages was lower than expected. On the revenue side, ISTAT attributed to 2020 tax payments that were deferred to 2021, which resulted in some 9.7 billion (0.6 percent of GDP) higher-than-expected tax and contribution revenue in 2020.

Beside these factors, the result of 2020 shows that the countercyclical fiscal policy measures adopted in 2020, in particular those aimed at safeguarding employment and corporate liquidity, have been effective in stabilising the economy, and that the actual deficit has been lower than expected.

FIGURE I.3: GENERAL GOVERNMENT DEFICIT AND PRIMARY BALANCE, EDP (percent of GDP)

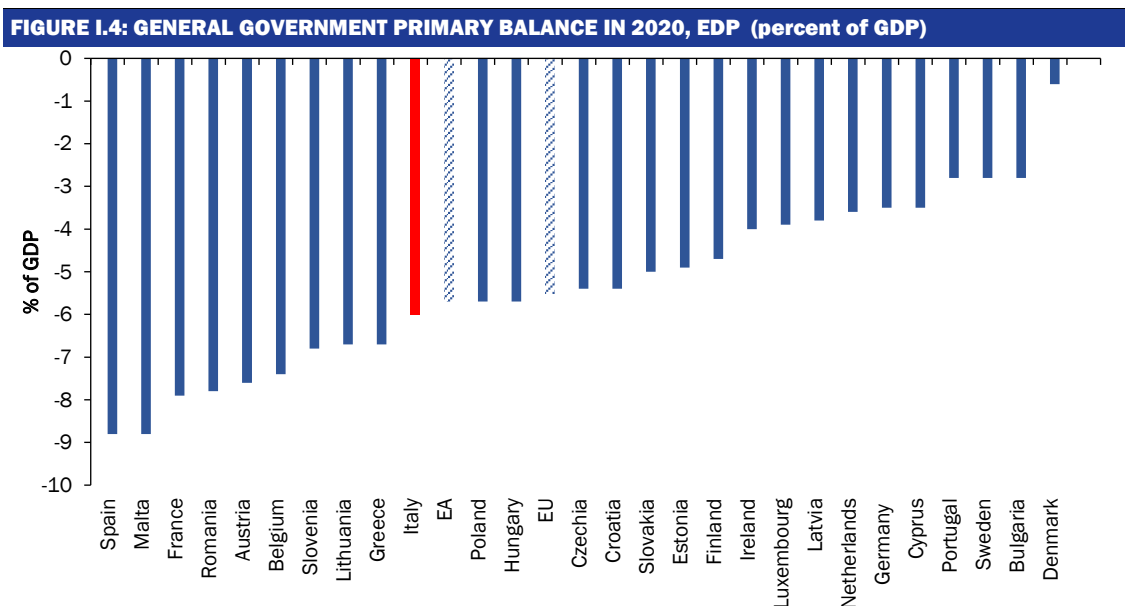


Source: ISTAT.

The worsening in net borrowing of last year was the combined result of the deterioration of the primary balance, which turned from a surplus of +1.8 percent of GDP in 2019 to a deficit of -6.0 percent in 2020, and the slight increase of interest expenditure as a share of GDP, from 3.4 percent to 3.5 percent. The latter was exclusively due to the sharp fall in GDP as in 2020 nominal interest expenditure continued to decline for the eighth year in a row.

The primary deficit of 2020 stands out for its exceptionality and interrupts the long string of surpluses that was only interrupted once, in 2009, and with a primary deficit worth less than 1 percent of GDP.

¹ Given the high uncertainty about the preparation of economic and financial forecasts, the forecasts presented in the 2020 Stability Programme covered only the 2020-2021 period and included, in addition to the impact of the decrees *Cura Italia* and *Liquidità* already adopted in the first months of 2020, the impact expected from the announced decree *Rilancio*, approved after the presentation of the document.



Source: MEF analysis on Eurostat data.

Since the economic and financial crisis of 2009, fiscal consolidation has been a central feature of Italy's economic policy: Italy has been recording one of the highest primary surpluses in the Euro area and the European Union. The deterioration of public finance in 2020 is a common feature of all European countries, which also showed large primary deficits. The primary deficit of the Euro area was -5.7 percent of GDP.

As a result of the outsized deficit and a very unfavourable snow-ball component,² Italy's debt-to-GDP ratio in 2020 increased by more than 21 percentage points, reaching a new high of 155.8 percent. At the end in 2019, general government debt stood at 134.6 percent of GDP. The flat annual change in the debt-to-GDP ratio in 2019, along with the positive budgetary data for that year and the cash-based data of the first two months of 2020, highlights the underlying improvement in Italy's public finances before the pandemic occurred.

The debt-to-GDP ratio in 2020 was actually lower than estimated back in early October. Indeed, in the 2020 Update the debt-to-GDP ratio forecast was 158.0 percent. The result mainly reflects better cash balances than expected: in 2020, public sector borrowing requirement stood at 9.5 percent of GDP, instead of 11.8 percent as expected and, in turn, the annual government debt growth rate was +6.8 percent instead of +8.0 percent. Finally, the debt-to-GDP ratio outturn for 2020 is very close to the forecast in the 2020 Stability Programme, 155.7 percent.

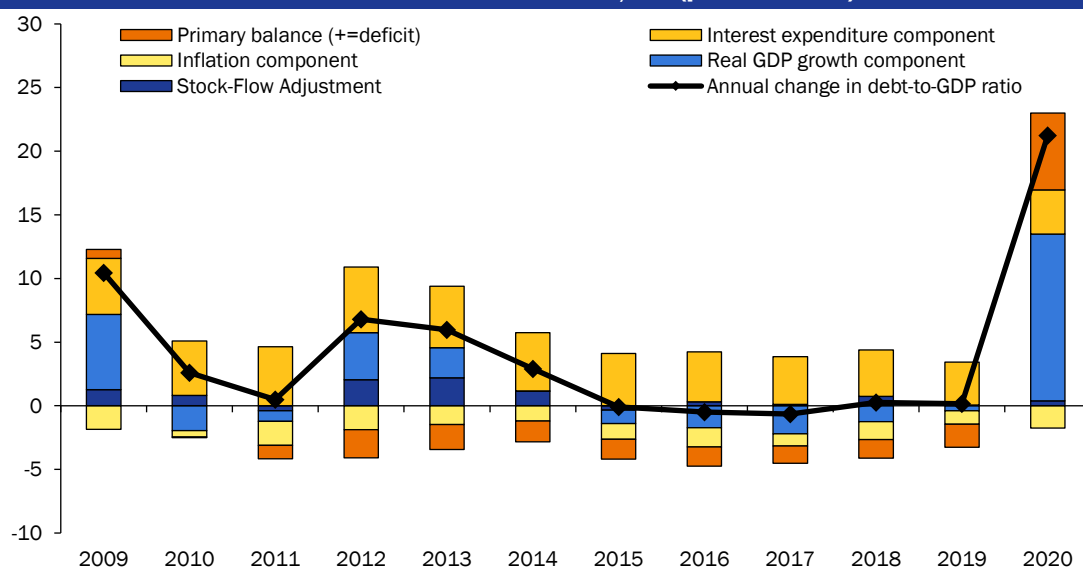
The attainment of a significant primary surplus has been traditionally contributing to the stabilisation of the debt-to-GDP ratio in recent years. In 2020, instead, the mitigating effect of the primary surplus vanished. Also, there was a very unfavourable snow-ball effect, which weighed by almost 15 percentage points on the annual change in the GDP debt ratio. The stock-flow component contributed to the increase in the debt ratio in 2020 by around 0.4 percentage points. This was also due to: i) the

² The snow-ball effect quantifies the automatic impact of the difference between passive interest and nominal GDP growth on the dynamics of the debt ratio.

weighting of the stock-flow due to the difference between the assessment of the impact of relief measures taken in response to the Covid-19 crisis on budget balances with the criterion of competence (deficit) and cash (borrowing requirement); ii) the increase in the cash holdings of the Treasury at the Bank of Italy of around 0.6 percentage points of GDP.

The inflation component was the only reducing driver of public debt-to-GDP ratio, accounting for -1.7 percentage points.

FIGURE I.5: KEY DRIVERS OF GENERAL GOVERNMENT DEBT, EDP (percent of GDP)



Source: MEF analysis on ISTAT data.

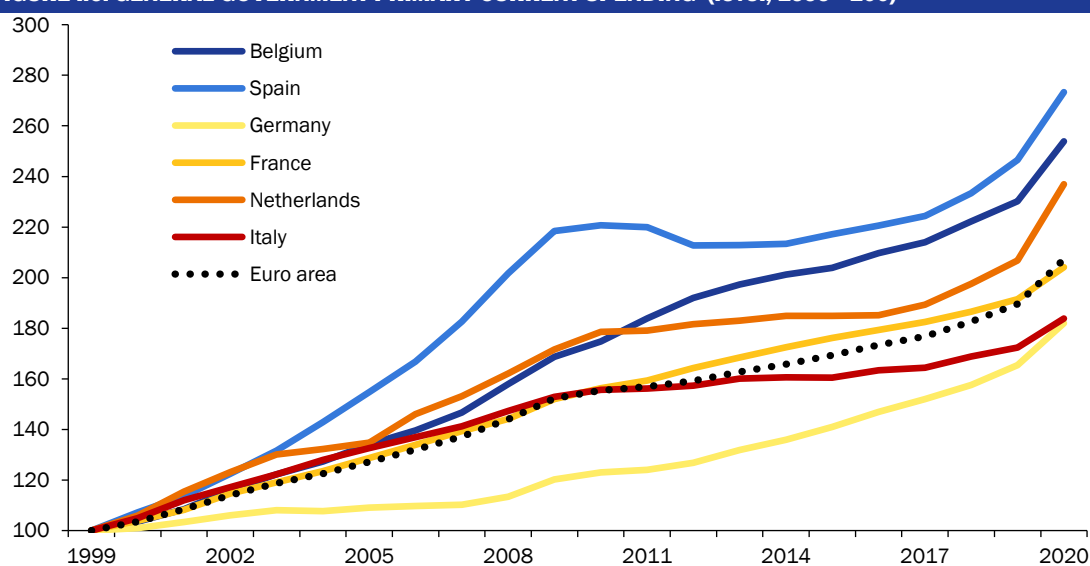
Despite the stabilisation of the debt-to-GDP ratio of the latest years, the criterion underlying the debt rule has not been met for a prolonged period. Italy has repeatedly challenged the excessive fiscal restriction implied by full compliance with the rule in a context of weak cyclical conditions and deflationary pressures.

The significant budget deficit that has been recorded in 2020, and the deficit projections updated in the 2021 Stability Programme for the current year and the following three years, make the fulfilment of the debt rule quite challenging. The lowest deviation from the three benchmarks envisaged by the debt-reduction rule is achieved in the cyclically adjusted configuration³. This supports the argument that the debt-reduction path should reflect the specific macro-economic and fiscal circumstances that each country faces.

Previous reports on debt developments ex art. 126.3 TFEU stressed the moderation in Italy's noninterest expenditure. After years of stability in nominal expenditure, the moderate increases recorded in 2018 and 2019 were driven by social inclusion measures, notably the introduction of the Citizenship income. Poverty alleviation became a priority of Italy's reform agenda due to growing income inequality and in line with the Council's Country Specific Recommendations (CSRs).

³ See table III.13, page 97, of the Italian Stability Programme.

In 2020, the year-on-year change in current primary expenditure was 6.7 percent in nominal terms, driven by social benefits (+10.6 percent). Non-pension benefits were the most dynamic item (+36.3 percent) due to the exceptional increases in expenditure on social safety nets introduced in favour of employees, self-employed workers and particular categories of workers to mitigate the economic and social effects of the epidemic crisis. The implementation of these measures should be deemed in line with the CSRs for 2020, which called on Member States to introduce all necessary measures to effectively address the Covid-19 pandemic and promote economic recovery. Nevertheless, it is worth pointing out that trend in Italy's current noninterest expenditure has remained more moderate than those of other Euro area member states.

FIGURE I.6: GENERAL GOVERNMENT PRIMARY CURRENT SPENDING (level, 1999= 100)


Source: MEF analysis on Eurostat data. For Italy, current noninterest expenditure net of the € 80 measure, increased to € 100 as for July 2020.

In 2020, public employment costs grew at a rate of only 0.3 percent, following a 0.2 percent increase in 2019. That confirms the return of Italy's public sector compensation to the previous trend following a 3.2 percent increase in 2018, which was due to a new public-sector labour contract covering three years ending in 2018 (with the attendant payment of arrears). The ratio of compensation to GDP declined in 2020, and on a comparative basis its share of GDP is only higher than Germany's.

TABLE I.1: Compensation of employees: General Government (€ bn)

	2013	2014	2015	2016	2017	2018	2019	2020
France	273,1	278,5	281,3	284,0	290,9	293,9	297,3	304,1
Germany	220,5	227,5	233,0	240,7	250,1	259,6	271,5	283,4
Italy	166,8	165,2	163,9	166,4	167,2	172,6	172,9	173,4
Spain	114,4	115,0	119,2	121,5	123,5	127,6	134,5	140,5

Source: Eurostat.

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

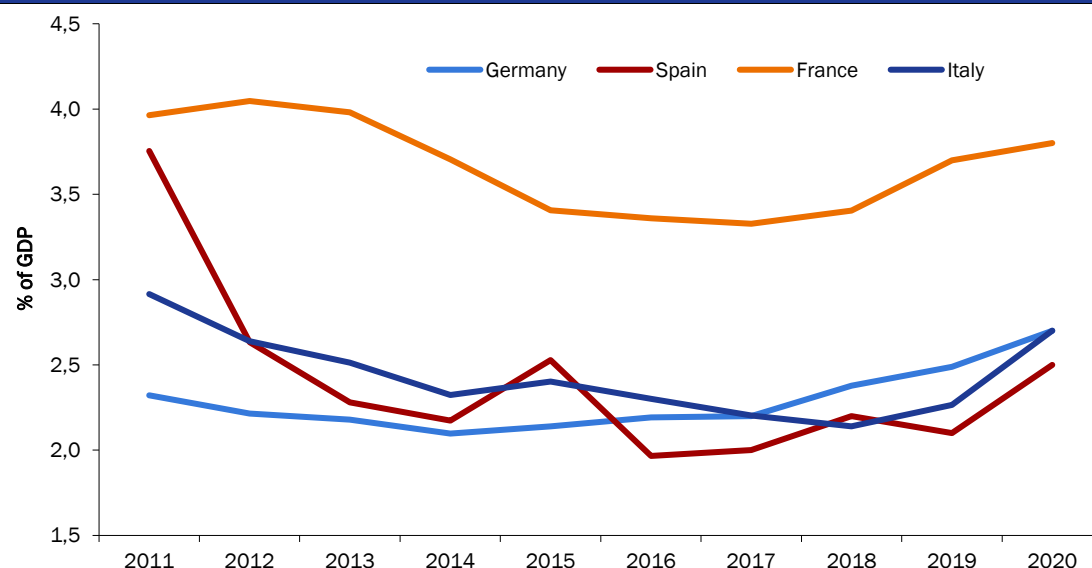
	2013	2014	2015	2016	2017	2018	2019	2020
France	12,9	13,0	12,8	12,7	12,7	12,4	12,2	13,3
Germany	7,8	7,8	7,7	7,7	7,7	7,7	7,9	8,5
Italy	10,3	10,2	9,9	9,8	9,6	9,7	9,7	10,5
Spain	11,2	11,1	11,1	10,9	10,6	10,6	10,8	12,5
EU	10,6	10,5	10,3	10,2	10,1	10,1	10,1	11,0

Source: Eurostat.

On the other hand, capital expenditure in 2020 increased by 45.6 percent. The unusual result is explained by the increase in other capital expenditures, which included the ESA expenditure related to loss provision for the standardized State guarantees for small and medium-sized enterprises, of about € 12 billion, and non-repayable contributions (reliefs) to support business activity, of about € 9 billion, introduced in response to the Covid-19 crisis.

Despite repeated lockdowns, plant lockouts and limitations to movements of persons, the performance of investment spending was positive, with an increase of € 2,772 million compared to 2019, due also to lower disposals from the extraordinary plan. Gross fixed capital formation grew by 6.7 percent, marking the second year of significant increase in public investment. Public investment rose to 2.7 percent of GDP, from 2.3 percent in 2019 and a low of 2.1 percent in 2018. Public investment is expected to increase further in coming years, mainly thanks to the Recovery and Resilience Plan.

FIGURE I.7: GENERAL GOVERNMENT FIXED CAPITAL FORMATION (percent of GDP)



Source: Eurostat.

II. ECONOMIC MEASURES TAKEN IN RESPONSE TO THE COVID-19 PANDEMIC

II.1 ECONOMIC RELIEF MEASURES TAKEN IN 2020

Key relief packages and their budgetary impact

In 2020, Italy was severely hit by the Covid-19 pandemic and followed a consistent policy to control the spread of the virus via social distancing, selective lockdowns and the closure of nearly half of the sectors of the economy. The Government responded through measures to support workers, businesses and households, knowing that it was crucial to minimize the adverse economic and social consequences and restart the economy as soon as the infection was brought under control.

The economic policy response to the first wave of the epidemic consisted of four law decrees that were adopted during the period between March and August 2020 (*Cura Italia*,⁴ Liquidity,⁵ Relaunch⁶ and the decree of August⁷). The bills were delivered in view of the economic consequences of the social distancing measures and plant lockouts that had been gradually introduced since March 2020.

Due to the resurgence of the epidemic, new restrictive measures were introduced for the containment of infections starting from October 2020 onwards. The restrictions were further tightened in November and differentiated across regions, which were identified according to different colours, from yellow to red, depending on the severity of the spread of the virus.

The Government approved four additional decrees containing selective measures to support households and businesses most affected by the second phase of the crisis.⁸ The sectors that were hit hardest by the second phase of the crisis were hotel accommodation, restaurants and bars, sports and entertainment, culture and organisation of trade fairs and other events.

These decrees were incorporated as amendments into a single bill of conversion of the first one, so-called *Ristori* or Relief Decree.⁹ The impact on the deficit deriving from the *Ristori* decree was estimated at less than € 8 billion, based on a budget space of € 5.4 billion, 0.3 percent of GDP, resulting from a take-up of supportive measures introduced until August 2020.

The preliminary step to the adoption of the bills was an authorisation from the national Parliament to raise the deficit objectives, after informing the European

⁴ D.L. No. 18/2020 (cvt. by Law No. 24/2020).

⁵ D.L. No. 23/2020 (cvt. by Law No. 40/2020).

⁶ D.L. No. 34/2020 (cvt. by Law No. 77/2020).

⁷ D.L. No. 104/2020 (cvt. by Law No. 26/2020).

⁸ Decrees No. 137 of 28 October 2020, No. 149 of 6 November 2020, No. 154 of 23 November 2020 and No. 157 of 30 November 2020.

⁹ D.L. No. 137/2020 (cvt. by Law No. 176/2020).

Commission, as required by Italy's fiscal rules. As for the financial impact of the *Ristori* decree, the Government obtained the fourth parliamentary approval to raise the general government net borrowing by a further 8 billion for 2020 (0.5 percent of GDP).

The deficit authorisation obtained from Parliament over the course of 2020 were consistent with domestic fiscal rules (Law 243/2012) and with the EU decision to invoke the General Escape Clause with respect to the provisions of the Stability and Growth Pact.

TABLE II.1 BUDGETARY IMPACT OF THE RELIEF PACKAGE ADOPTED IN 2020 IN RESPONSE TO THE COVID-19 PANDEMIC (€ millions)

	2020	2021	2022	2023	2024
D.L. No. 18/2020 (cvt. by Law No. 24/2020)	-19,989	2	2	1	1
D.L. No. 23/2020 (cvt. by Law No. 40/2020)	-11	0	0	0	0
D.L. No. 34/2020 (cvt. by Law No. 77/2020)	-55,289	-26,082	-34,705	-35,366	-36,332
D.L. No. 104/2020 (cvt. by Law No. 26/2020)	-24,876	-5,284	-755	-6,114	-4,926
D.L. No. 125/2020 (cvt. by Law No. 159/2020) (1)	1	0	126	84	0
D.L. No. 137/2020 (cvt. by Law No. 176/2020)	-7,985	10	0	4	0
IMPACT ON ESA-2010 NET BORROWING	-108,148	-31,355	-35,332	-41,390	-41,257
% of GDP	-6.5	-1.8	-1.9	-2.2	-2.1
IMPACT ON BORROWING REQUIREMENT	-122,113	-31,819	-35,049	-37,655	-37,944
% of GDP	-7.4	-1.8	-1.9	-2.0	-1.9

(1) The decree postponed to 31 January 2021 the state of emergency and the validity of preventive measures. The impact on public finance is negligible and mainly related to the postponement of terms for tax collections and for some hires in the public sector.

Source: Italy's 2021 Stability Programme.

The overall *ex ante* impact on the net borrowing of the general government in 2020 is € 108.1 billion (6.5 percent of GDP).

The impact presented in Table II.1 must be slightly adjusted in order to reconcile it with the provisional estimates for 2020 released by ISTAT on 2 April and with the public finance projections of the 2021 Stability Program. In particular, the impact of 6.5 percent of GDP for 2020 is to be reduced by about 0.6 percentage points, because of the assumption used by ISTAT according to which tax and social contribution deferrals to 2021 and 2022 do not impact the 2020 deficit, based on the ESA accrual principle for statistical recording. This approach also implies a higher impact of 0.5 percentage points of GDP in 2021 and 0.1 pp. in 2022. Consequently, the size of discretionary measures taken in 2020 is worth 6.0 percent of GDP in 2020, 2.3 percent of GDP in 2021 and 2.0 percent of GDP in 2022, while the impact for 2023 and 2024 remains unchanged, at 2.0 percent and 1.9 percent of GDP, respectively.

These estimates include the repeal, as per the 'Relaunch' decree, of increases in VAT and excise duties foreseen in existing legislation and that would have gone into effect in 2021 and the following years. The foregone revenue from repealing these tax hikes is € 19.8 billion in 2021 and € 27.3 billion in 2022. The rationale for cancelling these prospective increases in indirect taxation was that they would be inconsistent with the goal of supporting the economy during the pandemic and the early stages of recovery from the crisis.

Finally, the size of emergency measures summarised here does not include measures introduced with the 2021 Budget Law, which can be considered related to the Covid-19 emergency as well, or aimed at supporting the recovery of the economy. Their impact on net borrowing was of -1.4 percent of GDP in 2021 and -0.7 percent of GDP in 2022.

Main economic support measures

The 2020 package intervened along the following main areas:

- Strengthening the national health care system.
- Labour market measures to protect incomes and employment and prevent a worsening in inequalities.
- Selective support measures for firms, inclusive of fiscal allowances on fixed costs, non-refundable contributions and incentives for recapitalisation.
- Specific support measures for the most affected sectors, such as transportation, lodging, restaurants, bars, entertainment, sport and education.
- Reduction of tax burden by cancelling certain tax payments.
- Credit and liquidity measures to support firms and households, including the deferral of tax payments, a loan moratorium, the revision of the Deferred Tax Asset discipline, faster payments of the public administration to its suppliers.
- Providing State guarantees on bank loans, especially for SMEs.

Since the beginning of the pandemic, resources available to the **health system** and the civil protection have been progressively increased in order to ensure staff, tools and means necessary to assist people affected by the disease and contain the epidemic, for a total amount of € 8.2 billion in 2020, € 1.3 billion in 2021, € 1.9 billion in 2022 and € 1.4 billion annually in 2023 and 2024. Specifically, resources were allocated to the Department of Civil Protection and the Commissioner for the Covid-19 Emergency to cover the purchase of medical and personal protection devices and other supplies; to increase the capacity of hospital facilities; and to purchase equipment for intensive and sub-intensive care departments. New hiring of doctors and medical personnel, including military staff and the increase in the number of postgraduate scholarships, were also financed.¹⁰

Labour market interventions extended the three existing wage supplementation schemes: the Ordinary Wage Supplementation Fund (CIGO), the Wage Supplementation Fund (FIS) and the Extended Wage Supplementation Fund (CIG *in deroga*) to all

¹⁰ The Budget Law for 2021 provided for additional resources to the healthcare sector. In particular, the funding of the National Health System was increased by EUR 1 billion in 2021 and it was adopted the national strategic plan for vaccines for the prevention of SARS-CoV-2 infections (approximately EUR 0.6 billion in 2021) and the purchase of SARS-CoV-2 vaccines and medicines for the treatment of patients with covid-19 (EUR 0.4 billion in 2021).

companies forced to reduce or stop their activity due to the epidemic. The resulting increase in government outlays for social benefits is estimated at € 18.5 billion in 2020.

The first Ristori decree (No. 137 of 28 October 2020) extended the wage integration schemes, allowing the use of up to additional 6 weeks of the furlough fund (through CIGO, CIG *in deroga* or with causal Covid-19) in the period from 16 November 2020 to 31 January 2021.^{11 12}

As an alternative to the use of wage supplementary schemes, the package offered an exemption from social security contributions. Also, firing for economic reasons was prohibited for the duration of the emergency period.

One-off allowances were granted to self-employed workers, tourism workers, farm workers with special requirements and VAT registered professionals, for a total expenditure of € 9.2 billion in 2020.

Non-refundable transfers to firms were first introduced with the ‘Relaunch’ decree in May 2020¹³ and then revised by the *Ristori* decree, which attributed such transfers to 164 specific economic subsectors identified by ATECO code based on the restrictions introduced since late October. The number of identified subsectors increased in the final weeks of the year, as restrictions were tightened and the number of regions in the orange and red categories increased. The new contribution covered almost all the housing and catering activities and the recreational and entertainment sector.

The new non-repayable contribution covered all firms and VAT holders, not only those with a turnover of up to € 5 million; it was commensurate to the same loss of reference as the contribution of the Relaunch decree. The amount was computed by weighting the non-refundable contribution of the Relaunch Decree, which was differentiated by turnover classes as explained, by means of specific coefficients depending on the sector (ATECO code) and consequently depending on the intensity of the restrictions suffered for the different Decrees of the Prime Minister.¹⁴

The Relaunch decree contained important provisions to encourage the **recapitalisation of Small and Medium-sized Enterprises (SMEs)**.

Firstly, capital increase operations for SMEs that fulfil several conditions were supported, **by means of a tax credit** in favour of the transferring shareholder and to

¹¹ The decree introduced two main changes. On the one hand, all the employed on the date of 9 November 2020 could benefit from the additional weeks of wage integration, as already envisaged by the August decree, which *de facto* provided for the enlargement, although to a limited extent, of the number of beneficiaries. On the other hand, the decree required that, in order to use the new weeks until the end of January 2021, the firms should have already been authorised to use all the 18 weeks already granted by the decree of August.

¹² Lastly, the Budget Law for 2021 extended the schemes by providing a further 12 weeks between 1 January and 31 March 2021 for beneficiaries of CIGO and the causal covid-19, and 12 weeks between 1 January and 30 June 2021 for beneficiaries of FIS and the CIG *in deroga*.

¹³ The amount of the contribution was initially computed by weighting on the actual loss (difference between the turnover in April 2020 and in April 2019) on the basis of decreasing weight depending on three turnover classes: i) 20 percent in the case of revenues or compensations up to 400 thousand euros; ii) 15 percent for revenues or compensations from EUR 400 thousand to EUR 1 million; iii) 10 percent for revenues or compensations exceeding EUR 1 million and up to EUR 5 million.

¹⁴ Ranging from 30, 50, 100, 150, 200, to 400 percent.

the beneficiary company.¹⁵ To benefit from the credit, the investment should be made in one or more corporates: i) having legal residence in Italy (or permanent establishments in Italy of undertakings established in Member States of the European Union or in countries belonging to the European Economic Area); ii) suffering due to the Covid-19 emergency an overall reduction in revenues in March and April 2020, compared to the same period 2019, of at least 33 percent.

The 2021 Budget Law raised the cap of the tax credit for the recipient company from 30 to 50 percent for the capital increases approved and paid in the first half of 2021. The distribution of any kind of reserves before 1 January 2024 by the company (or 1 January 2025 in the event that the capital increase is approved and executed in the first half of 2021) entails the revocation of the benefit and the obligation to repay the amount, together with legal interest.

Secondly, the Relaunch decree provided for the establishment of an **Equity Fund for SMEs** that meet certain conditions and whose aim is to subscribe by 30 June 2021 -as extended by the Budget Law 2021- new bonds or debt securities issued by SMEs in order to contribute to their capital strengthening. The Fund's subscription of financial instruments must be within the limits of its total allocation (€ 4 billion) and, in any case, for subscriptions to be made in 2021, up to a maximum of € 1 billion.

The financial instruments shall be reimbursed six years after their subscription. However, the issuing company has the option of repaying the securities in advance after three years of subscription.

Thirdly, the *Rilancio* decree established a further fund, **Patrimonio Destinato**, under the umbrella of *Cassa Depositi e Prestiti* (CDP), intended for operations in viable businesses with a turnover of more than € 50 million. The fund may carry out interventions at market conditions or according to the criteria that will be defined by the temporary framework on State aid approved by the European Commission, and will preferably be carried out in a standardised manner, in the form of the subscription of convertible or subordinated loans, and purchase of shares listed on the secondary market in the case of strategic transactions. The subscription of capital will instead require a specific investigation, will not lead to the acquisition of controlling interests, and will normally see the presence of co-investors.

Patrimonio Destinato will also be able to intervene in restructuring operations of companies in crisis with prospects of recovery. The evaluation of the interventions takes into account, inter alia, the impact of the company with regard to technological development, critical and strategic infrastructures, strategic production chains, environmental sustainability, employment levels and the labour market.

It was constituted by means of the supply of assets by the Ministry of Economy and Finance (MEF). For this purpose, in 2020 the allocation of government or liquidity

¹⁵ On the one hand, a tax credit of 20 percent of the amount paid, with a maximum investment cap of EUR 2 million, is granted to the investors, provided that: the capital increase has been subscribed and paid up by 31 December 2020, and investors undertake to hold the stake in the company until 31 December 2023. On the other hand, the recipient company is entitled to a tax credit of 50 percent of the losses exceeding the 10 percent of the net equity (taken before losses). The amount of the tax credit should not be higher than the 30 percent of the capital increase and, in any case, be within the limits laid down in the State aid framework in the context of the current Covid-19 pandemic.

securities to CDP was authorised up to a maximum of 44 billion. The contribution of MEF corresponds to the issuance, by CDP S.p.A. of financial instruments of participation in favour of MEF embedded within the heritage.¹⁶

The draft implementing decrees of the primary discipline have been submitted to the Parliament, for examination by the competent parliamentary committees. The Ministerial Decree laying down the regulation on access requirements, conditions, criteria and modalities of interventions of the assigned heritage (Ministerial Decree of 3 February 2021), was recently published in the Official Journal on 10 March 2021.

Beside the repeal of indirect taxation increases provided for by current legislation, which was financed with the resources made available in the Relaunch decree, the emergency package cancelled a few **tax payments**, such as the balancing 2019 IRAP payment and the first instalment of this tax due for 2020, and the first and second instalment of IMU (the municipal tax on real estate) for certain productive activities particularly affected by the pandemic. As already explained, reductions in social contributions were allowed for certain productive sectors or employed in disadvantaged areas of the country.

Other measures included the **postponement of tax payments** due by certain categories of workers and businesses in the months of March, April and May 2020 and those due in November and December 2020, as provided by the *Ristori* decree. Tax and contributions postponed should be repaid in a single settlement or by instalments, up to a maximum of twenty-four monthly instalments.¹⁷

Liquidity support measures mainly implied increasing expenditure appropriations of the State budget and did not affect the government net borrowing. According to the credit moratorium introduced by the *Cura Italia* decree, banks were required to maintain existing credit lines to small and medium-sized enterprises (SMEs), including unused margins.¹⁸ The State provided banks with a one-third guarantee on new lending related to the portfolio constraint. Also, the moratorium suspended the payment of loan instalments or leasing fees, including mortgage loans on first residences via an increase in the ‘Gasparrini Fund’.

The credit moratorium was progressively extended: initially, from end September 2020 to end January 2021 (end March 2021 for tourism companies) and, subsequently, until end June 2021 by the Budget Law for 2021. The latter postponement was made possible by the extension of the Temporary Framework for State aid.

In addition to the moratorium *ex lege*, banks promoted additional moratoria either individually or via the banking associations. It is worth mentioning the three Addenda signed on March 6, May 22 and December, 17 of 2020 by the Italian Banking Association

¹⁶ The heritage ceases to exist *ex-lege* twelve years after its establishment; however, its duration may be extended or anticipated by a decision of the CDP Board of Directors, following a request by MEF.

¹⁷ Payments suspended in November and December 2020 should be made in a single settlement by the end of March 2021 or by instalment with the first instalment payment to be done by the same date.

¹⁸ In order to benefit of the moratorium, the law required firms to be *in bonis* at the time of the application for the measure, i.e. the firm must not have debt positions classified as non-performing loans, probable defaults, and expired and/or impaired exposures. In particular, it must not have expired instalments (i.e. not paid or paid only partially) for more than 90 days.

(ABI) and Associations representing signatories to the Credit Agreement for 2019, including *Confindustria*. These addenda provided, in relation to micro firms and SMEs, the option for banks and financial intermediaries to: (i) suspend up to one year the payment of the capital share or principal and interest quota of loan instalments; (ii) extend the maturity of loans (so-called ‘Businesses in Recovery 2.0’ measure). The deadline for the submission of applications was postponed until the end of March 2021.

II.2 RECENT MEASURES

Additional packages in response to the pandemic

The Government intends to continue supporting the economy by first and foremost compensating the workers and businesses most affected by the healthcare and contagion containment measures that were deemed necessary in the first half of 2021, due to the coronavirus diffusion. Supporting the economy is important not only for reasons of solidarity and social cohesion, but also to prevent the permanent shutdown of companies that would be viable under normal economic conditions, thus avoiding a permanent loss of the country’s potential GDP.

In March, a new Decree-Law (so-called *Sostegni decree*)¹⁹ was finalised in order to introduce a wide range of measures designed to support businesses and workers and the industries most affected by shutdowns, relying on the € 32 billion margin already requested by the previous administration on 15 January. Among others, the bill intervened in the following areas:

- Health and safety: additional resources for the healthcare system aimed, among others, at the purchase of Sars-Cov-2 vaccines and medicines and the strengthening of the vaccination plan and of financial support to research and industrial conversion of the biopharmaceutical sector to the production of new medicines and vaccines. Refinancing of funds for police and armed forces.
- Providing additional relief for businesses, professionals, agricultural firms: according to the new rules, the non-refundable contribution is recognised to those have suffered, between 2019 and 2020, a reduction in the average amount of turnover and fees of at least 30 percent. The amount of the contribution is determined as a percentage of the difference in turnover recognised and may not exceed € 150 thousand. As an alternative, it is possible to receive a tax credit.
- Selective interventions in the sectors most affected by the emergency: measures in support of ski resorts and of trade fairs.
- Work and social inclusion: refinancing of the furlough fund (CIGO, CIG *in deroga*, FIS) and income support by means of a one-off benefit for seasonal workers in tourism, spas, entertainment and sport. Also, the supplementary benefits provided by the Air Transport Solidarity Fund to companies in the sector has been extended. Refinancing of the fund for the Citizenship income and for emergency income with an extension of the number of beneficiaries.

¹⁹ Decree Law No. 41 of 22 March 2020.

- Further exemption of social security contributions: for the self-employed and professional workers, in addition to those already provided for in the 2021 Budget Law for farms, fisheries and aquaculture.
- Local and regional governments: transfers to compensate for revenue losses suffered as a result of the pandemic and to support local public transportation companies.
- Schools, universities and research: funding for the purchase of protection gear and medical supplies for diagnostic tests on the school population, and the implementation of psychological and pedagogical assistance services to students.

Together with the approval of the 2021 Stability Programme, the Government asked Parliament to authorise an additional margin of € 40 billion for a **new decree law** that will be issued in the coming weeks.

Thanks to this additional intervention, the supportive measures to businesses and households provided so far in 2021 would reach 4 percent of GDP, as compared with the 6.5 percent provided last year (6.0 percent if considering the anticipation to 2020 of taxes and contributions suspended and shifted due to the health emergency).

The Government hopes that this will be the last intervention of such magnitude, thanks to the increasingly positive epidemic and economic trends expected in the coming months. However, the pledge to support the economy for as long as necessary remains, should the need arise.

As regards the measures adopted, the new measure will mainly target self-employed workers and businesses and will channel resources into strengthening the resilience of companies most affected by shutdowns, credit availability and capitalisation. Priority will be given to speeding up interventions while safeguarding their fairness and effectiveness.

Economic revitalisation strategy for the coming years

Once the urgent measures will be completed, the fundamental component of the fiscal strategy for emerging from the crisis and returning to growth will be based on a strong boost to public investment. In addition to NGEU resources, the NRRP will be able to count on national funds that will bring the total budget of the Plan to € 222 billion over the 2021-2026 period; of this total, some € 169 billion will be a net increase over existing programs. These resources will be supplemented by some € 15 billion coming from the other components of NGEU, such as REACT-EU.

This recovery plan will boost public investment and incentives for private investment, research and development, digitisation and innovation. In order for this ambitious plan to be implemented, it will be necessary to simplify the regulations on public works and equip the Administrations involved with the necessary planning and management skills. In addition, it will be necessary to proceed rapidly with the structural reforms envisaged by the RRP, which concern in particular the Public Administration, justice, competition and taxation. The tax reform, to be finalised in the second half of 2021, will be linked to European and global advancements on issues such as environmental taxes and the taxation of multinationals. Tax collection mechanisms will also be further enhanced.

III. 2021 STABILITY PROGRAMME AND DEBT SUSTAINABILITY

III.1 MACROECONOMIC FORECASTS

The economic outlook continues to be influenced by the evolution of the pandemic. The spread of new and more contagious variants of the infection is continuing to affect GDP performance in the first quarter of 2021 and it is likely to influence also the economic dynamic in the current quarter. On the other hand, the vaccination campaign is gaining momentum and opens up the prospect of a gradual return to normality.

More than a year after the spread of the pandemic, the economic system seems to have reached some sort of coexistence with the virus. As highlighted in recent analyses²⁰, the resilience of the economy has grown, as firms adapt their production and administrative organization and households adjust their consumption patterns to social distancing and mobility restrictions.

On the supply side, the sectors that most reflect this trend are manufacturing and construction, not directly affected by measures to contain the virus and supported, in one case, by the recovery in world trade and, in the other, by numerous tax incentives. On the other hand, conditions in the service sector remain less favourable, due to several restrictions although restrictions have been relaxed at the end of April.

Foreign demand has recovered since the beginning of the year, especially with respect to trade flows with the EU.

Overall, the economic growth outlook for 2021 appears more muted than expected in the autumn, both because of a weaker carryover effect from 2020, due to the GDP reduction recorded in the last quarter of last year and to a subdued momentum at the start of 2021.

According to the vaccination programme announced by the Government, based on the expected availability of doses in the coming months, the immunization of at least 80 percent of the Italian population is expected to be reached by the autumn.

Consequently, limitation of productive activities, especially those of services requiring direct contact with the public, are expected to be gradually lifted during the second quarter and the summer.

In addition, the negative effects of the restrictions that affected the first months of the year have been mitigated by new fiscal policy interventions to support families and businesses with the adoption of Decree Law No. 41 of 22 March 2021, the so-called Decree 'Sostegni', amounting to 32 billion with an expansionary effect on GDP in the current year of around 0.7 percentage points.

²⁰ https://www.bancaditalia.it/pubblicazioni/note-covid-19/2021/mobility_restrictions_italy_second_wave.pdf

Further fiscal policy measures have been announced by the Government to support the economy in 2021 and underpin the recovery in the following period. Jointly with the approval of the Stability Programme, the Government asked Parliament to authorize an additional margin of € 40 billion for a new set of measures entering into force by the end of April, aiming to:

- Support families and businesses to overcome the emergency, strengthen the resilience of companies most affected by shutdowns, enhance credit availability and capitalisation;
- Strengthening the planned interventions within the RRP with an increase in resources compared to what previously provided for by the Budget Law for 2021;

In the Stability Programme policy scenario, GDP is expected to growth 4.5 percent this year, to accelerate slightly to 4.8 percent in 2022 and to moderate to 2.6 percent in the following year. In 2024, the growth rate would slow down to 1.8 percent, slightly below the growth in GDP in the baseline scenario, both because of the higher level achieved in the previous year, compared to the trend, and of the planned consolidation of the public finances.

**TABLE III.1: OFFICIAL MACROECONOMIC FORECAST – 2021 STABILITY PROGRAM (1)
(percentage changes, unless otherwise indicated)**

	2020	2021	2022	2023	2024
GDP	-8.9	4.5	4.8	2.6	1.8
GDP deflator	1.2	1.1	1.3	1.4	1.4
Deflator consumption	-0.2	1.0	1.3	1.4	1.4
Nominal GDP	-7.8	5.6	6.2	4.0	3.2
Employment (FTEs) (2)	-10.3	4.9	4.7	2.3	1.6
Employment (CLFS) (3)	-2.8	-1.0	3.2	2.1	1.6
Unemployment rate	9.3	9.6	9.2	8.5	8.0
Current account balance (balance as percent of GDP)	3.6	2.6	2.7	2.7	2.7

(1) Any inaccuracies result from rounding.

(2) Employment expressed in terms of Full-time equivalent units.

(3) Number of employees based on the sample survey of the Continuous Labour Force Survey (CLFS).

Thanks to this dynamic, GDP in the planning scenario would recover pre-crisis levels in the third quarter of next year, and then remain at higher levels throughout the forecast horizon.

Compared to the projections underling the baseline scenario, the highest growth is mainly driven by gross fixed capital formation. In particular, the plans announced by the Government allow gross fixed investment to return to its level in 2019 already in the last quarter of the current year. In addition, its share of GDP increases over the forecast horizon to slightly above 20 percent in 2024 (from around 18 percent in 2018-2019).

III.2 BUDGETARY AND DEBT PROJECTIONS

In the baseline scenario, net borrowing of the general government this year is projected to remain unchanged from 2020 (9.5 percent of GDP),²¹ higher than the 7 percent forecast of October's Draft Budgetary Plan (DBP), which was subsequently revised to 8.8 percent of GDP inclusive of the additional € 32 billion expenditure authorised by the Parliament on 15 January.

This upward revision reflects the impact of the 'Sostegni' Decree-Law (amounting to 1.8 percent of GDP), the worsening of the macroeconomic framework, and the carry-over to 2021 of taxes and contributions suspended and deferred due to the health emergency.

Thanks to the recovery of the economy, in the baseline scenario the deficit-to-GDP ratio declines sharply to 5.4 percent in 2022, 3.7 percent in 2023 and 3.4 percent in 2024 of the Programme. The policy scenario of the 2021 Stability Programme includes the following three main areas of intervention:

- A new package of support and recovery measures, soon to be approved and immediately implemented;
- The final version of the Recovery and Resilience Plan (RRP), which expands the overall resources envisaged in the 2021 Budget Law;
- Changes to the net borrowing reduction path, which reflect the longer duration of the pandemic crisis compared to the DBP assumptions.

Alongside the 2021 Stability Programme approved by the Council of Ministers on 15 April, the Italian Government submitted a Report to Parliament whereby it required the raising of the net borrowing and net balance to be financed for this year and the modification of the convergence path towards the Medium-Term Objective (MTO) for the coming ones.

Having obtained Parliament's authorisation, the Government will approve a decree-law containing new measures to support and revitalise the economy. The package will amount to about € 40 billion in terms of net borrowing of the general government in 2021; the impact on the deficit in subsequent years will vary between € 4 billion and € 6.5 billion, and will be aimed at financing public investment with additional resources to those provided by the RRF.

Given the magnitude of the decree-law currently being drafted, the policy scenario of the Stability Programme projects a significantly higher deficit for the year 2021 than the unchanged legislation scenario, reaching 11.8 percent of GDP.

The policy objectives for the deficit are set at a slightly higher level than the corresponding unchanged legislation projection also in 2022 and 2023, while the deficit objective will converge to the projection under unchanged legislation in 2024.

Indeed, in the light of the second and third waves of the Covid-19 epidemic and the consequent need to support the economy, as well as the recommendation by the

²¹ The unchanged legislation (baseline) scenario considers the budgetary and macroeconomic impact of all legislation enacted before the date of issue of the document.

Parliament to strengthen the RRP, the Government deemed it appropriate to postpone the 3.0 percent deficit objective to 2025, in order to support a major effort to invest and regenerate the country.

TABLE III.2: PUBLIC FINANCE INDICATORS (% of GDP) (1)

	2019	2020	2021	2022	2023	2024
POLICY SCENARIO						
Net borrowing	-1.6	-9.5	-11.8	-5.9	-4.3	-3.4
Primary balance	1.8	-6.0	-8.5	-3.0	-1.5	-0.8
Interest expenditure	3.4	3.5	3.3	3.0	2.8	2.6
Structural net borrowing (2)	-1.7	-4.7	-9.3	-5.4	-4.4	-3.8
Structural change	0.6	-3.0	-4.5	3.8	1.0	0.6
Public debt (gross of financial aids) (3)	134.6	155.8	159.8	156.3	155.0	152.7
Public debt (net of financial aids) (3)	131.3	152.3	156.5	153.2	152.0	149.9
TREND SCENARIO UNDER UNCHANGED LEGISLATION						
Net borrowing	-1.6	-9.5	-9.5	-5.4	-3.7	-3.4
Primary balance	1.8	-6.0	-6.2	-2.5	-0.8	-0.8
Interest expenditure	3.4	3.5	3.3	3.0	2.8	2.6
Structural net borrowing (2)	-1.9	-4.9	-7.2	-5.0	-3.8	-3.9
Structural change	0.5	-3.1	-2.2	2.2	1.1	-0.1
Public debt (gross of financial aids) (3)	134.6	155.8	157.8	154.7	153.1	150.9
Public debt (net of financial aids) (3)	131.3	152.3	154.5	151.6	150.2	148.1
MEMO: 2021 Draft Budgetary Plan (POLICY SCENARIO)						
Net borrowing	-1.6	-10.5	-7.0	-4.7	-3.0	...
Primary balance	1.8	-7.0	-3.7	-1.6	0.1	...
Interest expenditure	3.4	3.5	3.3	3.1	3.1	...
MEMO: Update to the 2020 Stability Programme (POLICY SCENARIO)						
Net borrowing	-1.6	-10.8	-7.0	-4.7	-3.0	..
Primary balance	1.8	-7.3	-3.7	-1.6	0.1	..
Interest expenditure	3.4	3.5	3.3	3.1	3.1	..
Structural net borrowing (2)	-1.9	-6.4	-5.7	-4.7	-3.5	..
Change in structural balance	0.4	-4.5	0.7	0.9	1.2	..
Public debt (gross of financial aids) (4)	134.6	158.0	155.6	153.4	151.5	..
Public debt (net of financial aids) (4)	131.4	154.5	152.3	150.3	148.6	..
<i>Nominal GDP under unchanged legislation (absolute values x 1,000)</i>	1790.9	1651.6	1738.1	1835.8	1904.6	1965.3
<i>Nominal GDP under policy scenario (absolute values x 1,000)</i>	1790.9	1651.6	1743.8	1851.6	1925.2	1987.4

(1) Any inaccuracies are due to rounding.

(2) Net of one-offs and the cyclical component.

(3) Gross or net of Italy's share of loans to EMU Member States, either bilaterally or through the EFSF, and of the contribution to the capital of the ESM. At the end of 2020, the amount of these shares was approximately € 57.7 billion, of which € 43.4 billion for bilateral loans and through the EFSF and € 14.3 billion for the ESM programme (see Bank of Italy, 'Statistical Bulletin of Public Finances, Borrowing Requirement and Debt, April 2021'). The MEF's liquidity stock is assumed to be substantially stable; in addition, the estimates take into account the repurchase of SACE, the use of earmarked assets, and the EIB and SURE guarantees. The interest rate scenario used for the estimates is based on the implicit forecasts derived from the forward rates on Italian government bonds for the period in which this document was compiled.

(4) Gross of Italy's share of loans to EMU Member States, either bilaterally or through the EFSF, and of the contribution to the capital of the ESM. The MEF's liquidity stock is assumed to decrease by 0.2 percent of GDP in 2020 and 0.1 percent of GDP in 2021; moreover, the estimates take into account the repurchase of SACE, the use of earmarked assets, and the EIB and SURE guarantees.

The achievement of a net borrowing of 3.4 percent of GDP in 2024 will require expenditure savings and revenue increases that will be detailed in the 2022 Budget Law provided that the prospect of exiting the pandemic is reinforced in the autumn.

As regards the ratio of government debt to GDP, this year would see a further increase of 4 percentage points, up to 159.8 percent. A gradual reduction path will start from next year, with a decrease of 3.5 percentage points in 2022 and 3.6 percentage points, overall, in the following two years.

In the medium term, the low implicit cost of debt financing, which is estimated to be around 2.2 percent this year, should fall further, making it possible to reduce the debt-to-GDP ratio by at least 4 percentage points per year, provided that the nominal trend growth of the Italian economy returns to at least the level of the first decade of this century and the primary surplus gradually rises to 3 percent of GDP on a structural basis. According to the policy scenario, the ratio of gross public debt to GDP is projected to back towards the pre-crisis level (134.6 percent) by the end of the decade.

As mentioned by the Commission, the activation of the general escape clause “in response to the onset of the Covid-19 pandemic has allowed Member States to depart from the budgetary requirements that would normally apply.” At this stage, the general escape clause has been activated for the period 2020-2021, but it is reasonable to expect that it will remain in force also in 2022. Therefore, changes in the structural balance in 2020 and 2021 and, probably, in 2022 too, would not be subject to the rules of the SGP preventive arm.

TABLE III.3: CYCLICALLY ADJUSTED PUBLIC FINANCE (as percentage of GDP)

	2018	2019	2020	2021	2022	2023	2024
1. GDP growth rate at constant prices	0.9	0.3	-8.9	4.5	4.8	2.6	1.8
2. Net borrowing	-2.2	-1.6	-9.5	-11.8	-5.9	-4.3	-3.4
3. Interest expenditure	3.6	3.4	3.5	3.3	3.0	2.8	2.6
4. One-off measures (2)	0.1	0.1	0.1	0.2	0.2	0.1	0.0
Of which: <i>Revenue measures</i>	0.2	0.1	0.2	0.2	0.1	0.1	0.0
<i>Expenditure measures</i>	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0
5. Potential GDP growth rate	0.0	0.1	0.1	0.1	0.9	1.2	1.3
Factors contribution to potential growth:							
<i>Labour</i>	-0.2	-0.3	-0.2	-0.3	0.3	0.5	0.6
<i>Capital</i>	0.0	0.0	-0.2	-0.1	0.1	0.2	0.3
<i>Total Factor Productivity</i>	0.3	0.4	0.4	0.5	0.5	0.5	0.5
6. Output gap	-0.1	0.1	-8.8	-4.9	-1.2	0.1	0.6
7. Cyclical component of budget balance	0.0	0.1	-4.8	-2.7	-0.6	0.1	0.3
8. Cyclically adjusted budget balance	-2.2	-1.7	-4.7	-9.1	-5.3	-4.3	-3.7
9. Cyclically adjusted primary balance	1.5	1.7	-1.2	-5.8	-2.3	-1.5	-1.1
10. Structural budget balance (3)	-2.3	-1.7	-4.7	-9.3	-5.4	-4.4	-3.8
11. Structural primary balance (3)	1.3	1.6	-1.3	-6.0	-2.5	-1.6	-1.1
12. Change in structural budget balance	-0.4	0.6	-3.0	-4.5	3.8	1.0	0.6
13. Change in structural primary balance	-0.5	0.3	-2.9	-4.7	3.5	0.9	0.5

(1) Discrepancies, if any, are due to rounding. (2) The positive sign indicates one-off measures reducing the deficit. (3) Cyclically adjusted net of one-off and other temporary measures.

The evolution of the public finances in structural terms through to 2024 is presented in Table III.3, as calculated according to the commonly agreed methodology. Estimates should be interpreted with particular care. Indeed, at the current juncture macroeconomic and fiscal projections are subject to a high degree of uncertainty. This is particularly true of potential output estimates, which in turn affect the computation of the cyclical component. In addition, it has proved extremely difficult to quantify the temporary component of Covid-19 related measures. As a result, and consistently with the previous government projections presented in the Draft Budgetary Plan, their values are included in the structural component of the budget.

With the above caveats in mind, the change of structural budget for the year 2022 will be affected by the substantial temporary measures implemented this year. On the other hand, the budget estimates from the year 2023 should be regarded as more reliable. While the 2022 improvement of 3.8 percentage points of GDP is mostly due to the gradual phasing out of temporary expenditures linked to the pandemic emergency, in the following years the structural balance should post genuine improvements and ensure full compliance with the preventive arm of the SGP. It is worth noting that improvements in the structural balance are lower than the ones for the headline balance because the output gap turns positive in 2022.

TABLE III.4: SIGNIFICANT DEVIATIONS

Convergence of the structural balance towards the MTO	2018	2019	2020	2021	2022	2023	2024
Net borrowing	-2.19	-1.60	-9.50	-11.76	-5.92	-4.26	-3.40
Medium-Term Objective (MTO)	0.00	0.00	0.50	0.50	0.50	0.50	0.50
Structural balance	-2.30	-1.73	-4.74	-9.27	-5.42	-4.40	-3.75
Change in the structural balance	-0.09	0.35	-3.01	-4.53	3.85	1.02	0.65
Required change in structural balance (*)	0.30	0.42	-0.20	0.00	0.00	0.60	0.60
Deviation of the structural balance from required annual change (<0.5 pp)	-0.39	0.78	-2.81	-4.53	3.85	0.42	0.05
Average change in the structural balance (over two years)		0.13	-1.33	-3.77	-0.34	2.44	0.84
Required average change (over two years)		0.36	0.11	-0.10	0.00	0.30	0.60
Deviation of the structural balance from required average change (<0.25 pp)		-0.23	-1.44	-3.67	-0.34	2.14	0.24
Expenditure rule	2018	2019	2020	2021	2022	2023	2024
Growth rate of the reference expenditure aggregate (%)	1.89	1.47	10.08	8.60	-5.91	1.44	-0.11
Benchmark adjusted for cyclical conditions (**) (%)	0.50	0.51	1.70	1.11	1.45	0.46	0.53
Deviation of expenditure aggregate from annual required change (<0.5 p.p.)	-0.66	-0.39	-4.08	-3.78	3.75	-0.46	0.29
Deviation of expenditure aggregate from average required change over two years (<0.25 p.p.)	-0.48	-0.53	-2.24	-3.93	-0.02	1.64	-0.08

(*) The required change in the structural balance in 2018 was 0.3 due to the margin of discretion. The general safeguard clause of the Stability and Growth Pact is considered activated over the period 2020-2022. The flexibility granted in addition for 2020 is due to exceptional measures of safeguard and securing the territory.

(**)The benchmark takes into account the required change in the structural balance.

As far as the expenditure rule is concerned, it is reasonable to draw some conclusions only from the year 2023 onwards (see Table III.4). During the first two years of pandemic, the relevant expenditure aggregate is estimated to grow well above the benchmark that allows the structural balance to reach the Medium-Term

Objective. On the other hand, in 2022 primary expenditure is estimated to sharply decrease by almost 6 percentage points simply because emergency measures are expected to be discontinued.

Afterwards, primary expenditure is expected to increase by almost 1.5 percent in 2023 and close to 1.9 percent in 2024. Should the general fiscal framework be reinstated, the expenditure rule would require the annual growth rate of primary expenditure to remain around 0.5 percent in both 2023 and 2024.

However, apparent non-compliance with the expenditure rule would have to be qualified in light of the higher levels of public investment engendered by the RRP. Over the 2021-2024 period, net of subsidies, public investment will rise to around 3 percent of GDP. Strict compliance with the expenditure rule would require either an excessive cut in other expenditure components, or discretionary tax increases. Furthermore, the RRP aims at increasing economic growth over the medium term. Since the potential GDP projection methodology does not fully capture its effects, the expenditure benchmark is likely to be underestimated.

III.3 DEBT SUSTAINABILITY ANALYSIS²²

The previous section described the planned budgetary and debt projections underpinning the Italian Stability Programme. As it was pointed out, if the existing fiscal rules are reinstated starting from the year 2023, these projections point to compliance with the preventive arm of the Stability and Growth Pact.

In this section, we illustrate how the projected declining path of the debt-to-GDP ratio in the 2022-2024 time horizon of the Stability Programme is likely to be resilient to the uncertainty surrounding the forecasts. A debt sustainability analysis shows also that, given the commitment of the government to prolong the fiscal adjustment effort beyond the year 2024, the debt to GDP ratio will decline rapidly during the next decade; this result is contingent on a successful implementation of the RRP.

Stochastic simulations of debt dynamics

In what follows we provide a sensitivity analysis of the development of the debt-to-GDP ratio taking simultaneously into account the uncertainty inherent in the forecasts of the yield curve, economic growth and the public finances. This entails running stochastic simulations around the path of the policy forecast that reflect historical volatility of short-term and long-term interest rates, of nominal GDP growth and the primary balance. The simulations were carried out using the Monte Carlo method and applying stochastic *shocks* to the dynamic of the debt-to-GDP ratio of the Stability Program reference scenario. These shocks are simulated on the basis of the historical volatility of the relevant variables.

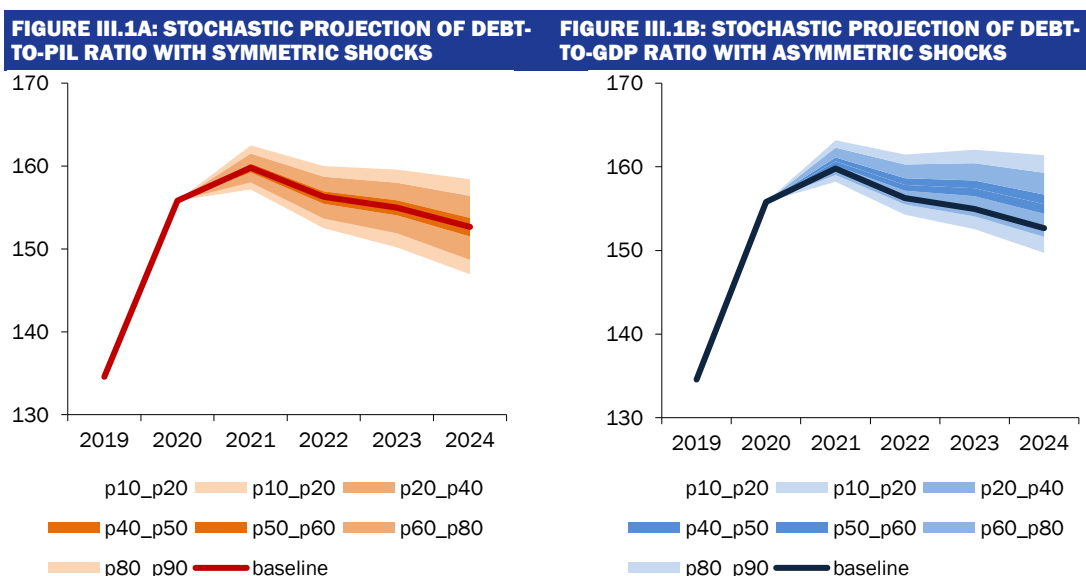
Two scenarios are considered. In the first, primary balance shocks are symmetrical, while in the second, negative shocks are given greater weight. The shocks

²² This section largely draws on sections IV.1 and IV.2 of the 2021 Italian Stability Programme, to which we refer for additional details on simulation methods and assumptions.

to nominal growth and short- and long-term rates of return are always symmetrical and are temporary in nature²³. For each forecast year and each type of shock to the primary balance (symmetrical and asymmetrical) it is possible to identify a distribution of the debt ratio represented through fan charts (Figures III.1A and 1B).

In the event of symmetrical shocks, debt is distributed around a median value of around 152.6 percent of GDP at the end of the time horizon, almost 18 percentage points higher than in 2019 (134.6), but 3.2 percentage points below the 2020 figure (155.8). The uncertainty over the 2024 results is relatively low, as shown by a difference of about 11.5 percentage points between the tenth and the ninetieth percentile of the expected debt distribution. After the sharp rise in 2020, the debt-to-GDP ratio would grow less sharply in 2021 and then, from 2022 onwards, it would follow a declining path in all simulated scenarios. In 60 percent of the scenarios, in 2024 the debt ratio would be below the value recorded in 2020.

Asymmetrical shocks result in a similar distribution of the debt-to-GDP ratio around the central scenario, but the trend and level differ significantly. The median value at the end of the period is 155.5, some 21 percentage points higher than in 2019 and 0.3 percentage points lower than in 2020 (155.8). After the rise in 2020-2021, in 60 percent of the simulated scenarios the debt-to-GDP ratio shows a declining trend; and even in the remaining cases, the trajectory is roughly stable over the horizon of the simulation.



Note: The graphs show the 10th, 20th, 40th, 50th, 60th, 80th and 90th percentiles of the debt-to-GDP ratio distribution obtained by stochastic simulation.
Source: MEF calculations.

²³ For further information on the methodology adopted, see Berti K., (2013), “Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries”, *Economic Papers* 480 and European Commission, 2020, Debt Sustainability Monitor 2019, Institutional Papers 120, available on: https://ec.europa.eu/info/sites/info/files/economy-finance/ip120_en.pdf.

Debt Sustainability Analysis

This section contains a sensitivity analysis of the debt-to-GDP ratio profile based on assumptions concerning GDP growth, the yield curve and primary balances. This allows the extrapolation of a range of scenarios projecting the dynamics of the debt-to-GDP ratio over a horizon that extends until 2032²⁴.

In view of the strategic relevance of the Next Generation EU (NGEU) Investment Plan, two scenarios have been implemented to incorporate, respectively, the full NGEU (NGEU-Fully-ON) effects and the absence of NGEU (NGEU-OFF) effects.

In the NGEU-F-ON scenario, the estimate of potential GDP is consistent with the government macroeconomic and fiscal policy forecasts extended to the year 2026, which go beyond the 2021-2024 horizon underlying the Stability Programme. These forecasts take into account the impact on the Italian economy of the NGEU along the whole (six-year long) time horizon of the RRP and the commitment of the government to further improve the budgetary outlook after the year 2024. From the year 2027 onward, GDP projections rely on the t+10 methodology developed by the Output Gap Working Group of the Economic Policy Committee, with the output gap closing linearly in 2029. The primary surplus is maintained at its structural level of the 2026 year until the end of the forecast horizon, while taking into account the evolution of age-related expenditure and property income.

As far as interest rates are concerned, it is assumed that the whole yield curve will gradually shift downwards with respect to the shape consistent with current market expectations. According to this assumption, by the end of 2025 the curve will have reached a 50 basis points reduction, which would be permanent from then onwards. This deviation would be associated with a reduced risk premium for the sovereign issuer, reflected by a reduction in the spread *vis-à-vis* Germany. Such an outcome is consistent with a consolidated improved outlook concerning growth prospects for the Italian economy resulting from an effective implementation of NGEU measures.

A variant of the NGEU-F-ON scenario, named BUDGET BALANCE, shows the path of the debt-to-GDP ratio assuming that additional fiscal adjustments are carried out after 2026. In this simulation, the structural balance is improved by 0.5 percent of GDP until a balanced budget is achieved (according to present fiscal figures, such goal would be reached in 2031); it also features an adverse feedback on economic growth as simulated in similar exercises carried out by the Commission. All other assumptions are in common with the NGEU-F-ON scenario.

At the opposite end of the spectrum, the NGEU-OFF scenario is based on an estimate of the growth rate of the economy in the absence of the NGEU plan, while keeping the same budgetary effort in structural terms as the NGEU-F-ON scenario. As far as interest rates are concerned, there is an upward shift of 50 basis points throughout the interest rate curve from 2022.

²⁴ Most of the scenarios are described in greater detail in paragraph IV.2 of the 2021 Italian Stability Programme.

Finally, an intermediate scenario (or “2024” scenario) projects beyond the year 2024 the GDP forecasts and debt estimates of the Stability Programme. No impact of the NGEU plan is forecasted beyond 2024: starting from 2025, economic growth is aligned with that of potential GDP estimated according to the “t+ 10” methodology. As far as public finances are concerned, in the medium term the primary structural balance is equal to the forecast value for 2024, while taking into account the evolution of age-related expenditure and property income. Interest rates are consistent with market expectations.

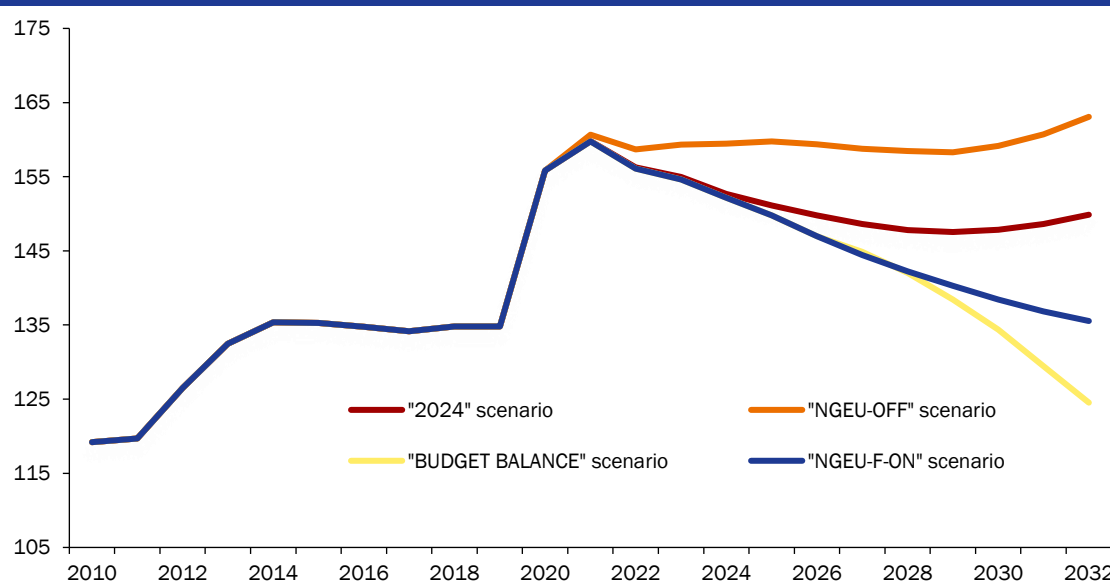
On the basis of the macroeconomic and public finance assumptions considered, the “2024” scenario shows (Figure III.2), after the sharp rise in the debt ratio in 2020 and 2021 (by about 24 percentage points), a marked reduction in the first years of simulation and a broad stabilization at the end. In 2032, the debt ratio reaches 149.9 percent.

In the “NGEU-F-ON” scenario, which incorporates full implementation of the NGEU plan, the debt-to-GDP ratio maintains a trend similar to that of the “2024” scenario until 2024 (the underlying assumptions are the same, except for the assumptions on interest rates, which are slightly more favourable in the “NGEU-F-ON” scenario). In subsequent years, the ratio continues to decline, reaching 135.5 percent in 2032, thus approaching the level recorded in 2019 (134.6 percent).

The BUDGET BALANCE scenario ensures an even faster decline in the final part of the simulation, as the debt ratio reaches 124.5 percent in 2032, albeit at the cost of a slightly lower output level. Indeed, due to the simulated impact of harsher fiscal tightening on growth, GDP in 2032 is 1 percent lower than in the NGUE-F-ON scenario.

In the NGEU-OFF scenario, which excludes the effects of the NGEU plan, the debt-to-GDP ratio remains broadly stable in the first part of the projection and then rises in later years, reaching 163.1 percent in 2032.

FIGURE III.2: MEDIUM-TERM PROJECTIONS OF DEBT-TO-GDP RATIO IN ALTERNATIVE SCENARIOS



Source: MEF calculations

III.4 PUBLIC GUARANTEES

Due to the Covid-19 epidemic crisis and the severe risk of liquidity crises for firms, in 2020 the Italian Government adopted several measures to safeguard firms' access to credit and to support their liquidity.

The granting of public guarantees was the main instrument oriented to this aim. Many European countries, taking advantage of the European Temporary Framework in State aid, extended the provision of public guarantees, but Italy had the advantage of a relatively low stock of guarantees accumulated until 2019 that allowed a significant room of manoeuvre. In 2020 the stock of public guarantees recorded an increase of around € 130 billion, rising to 215.5 billion in 2020 (13.0 percent of GDP) from € 85.9 billion in 2019 (4.8 percent of GDP).

The increase was due to both the measures adopted to counteract the effects of the crisis, which reached 7.1 percent of GDP, and the reform of the co-insurance system between State and SACE for export loan guarantees, which accounted for another 1.8 percent of GDP.

TABLE III.5: STOCK OF PUBLIC GUARANTEES IN 2020 (% of GDP)

	Measures	Date of adoption (1)	Maximum amount of potential liabilities	Take-up
Related to Covid-19	Central Guarantee Fund for SMEs	17/03/2020	n.a.	5.84
	SACE- Garanzia Italia	8/04/2020	12.11	1.16
	Commercial credits insurance	19/05/2020	0.12	0.12
	Subtotal			7.12
Other	Central Guarantee Fund for SMEs			1.24
	TAV S.p.A.			0.06
	Guarantees by local government			0.16
	GACS			0.63
	CDP bond issues			0.18
	First-home guarantee fund			0.53
	Fund for guarantee non-market risks in favour of SACE			3.08
	ILVA			0.02
	<i>Green New Deal</i>			0.01
	Subtotal			5.92
TOTAL			13.05	

1) The date refers to the regulatory provision that introduced or revised the guarantee scheme.

Concerning the guarantees directly linked to the pandemic, a first intervention was adopted with the '*Cura Italia*' decree²⁵ that extended the Central Guarantee Fund for small and medium sized enterprises (SMEs), both in terms of operability and resources. It showed a widespread usage during the crisis. As of 31 December 2020, guarantees granted by the State amounted to about € 117 billion, 90.5 billion higher than in 2019. Of these, the guarantees related to the crisis amount to 96.5 billion (5.8 percent of GDP).

²⁵ Law Decree No. 18/2020.

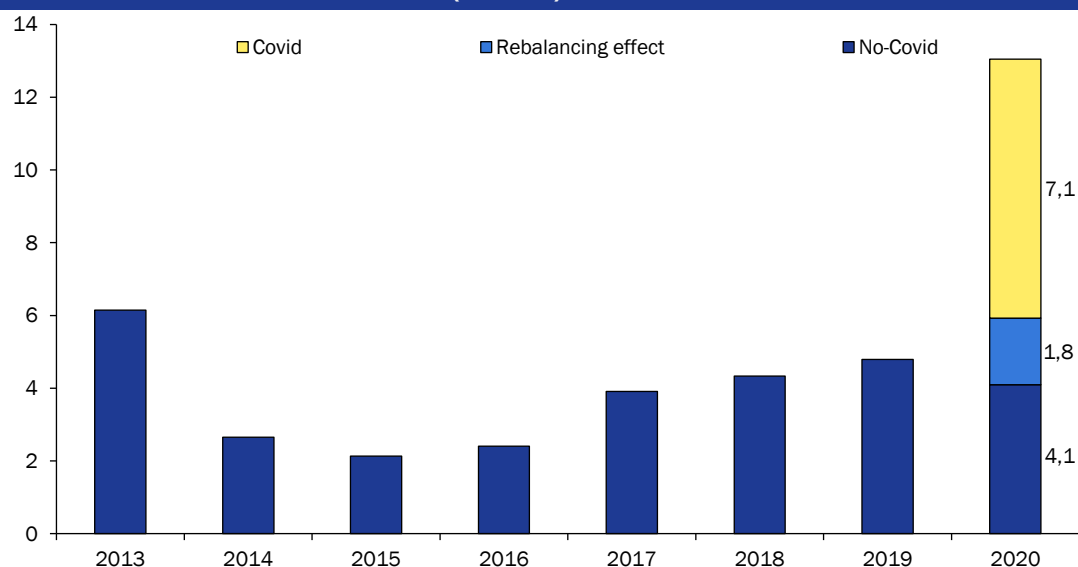
The ‘*Cura Italia*’ decree established another measure of liquidity support, the loan moratorium²⁶. Financial institutions may request a 33 percent subsidiary coverage from the Guarantee Fund, without assessing the creditworthiness of the final beneficiary. To this end, the decree established a special section of the Central Fund, with an initial allocation of 1.4 billion for the year 2020.

Furthermore, the ‘Liquidity’ decree²⁷ established the new guarantee fund ‘*Garanzia Italia*’, managed by SACE S.p.A., to facilitate access to credit for SMEs. At the end of 2020, the guarantees granted by the State reached a level of € 19.2 billion (1.2 percent of GDP) against a maximum amount of € 200 billion, as set by the law.

Finally, the ‘Relaunch’ decree²⁸ introduced a new form of reinsurance by SACE, equal to 90 percent, of commercial credits insured by private insurance companies that adhere to the programme by means of a special agreement. This agreement was activated at the end of 2020 and the guarantees reinsured by SACE amounted to € 2 billion (0.1 percent of GDP), equal to the legal ceiling.

As for the revision of the co-insurance system between SACE and the State, the State ensures part of the non-market risks already assumed by SACE for transactions concerning strategic sectors, relevant companies, or internationalization and export. The ‘Liquidity’ decree increased from 10 to 90 percent the share guaranteed by the State. This rebalancing of 90 percent State - 10 percent SACE resulted in an increased State exposure of about 30.2 billion (corresponding to 1.8 percent of GDP), i.e., more than half of the Fund that, at 31 December 2020, reached 51 billion (3.1 percent of GDP).

FIGURE III.3: PUBLIC GUARANTEES IN 2020 (% of GDP)



Note: The term rebalancing effect refers to the effect derived from the L.D. No. 23/2020, art. 2, that provides for the raise from 10 to 90 percent of the share reassured by the State of the commitments, both existing and new, of SACE in the field of supporting export and internationalization, with consequent increase of the State exposure.

Source: Up to 2019 Eurostat. 2020, MEF elaboration.

²⁶ Art. 56 of the decree.

²⁷ Law Decree No. 23/2020.

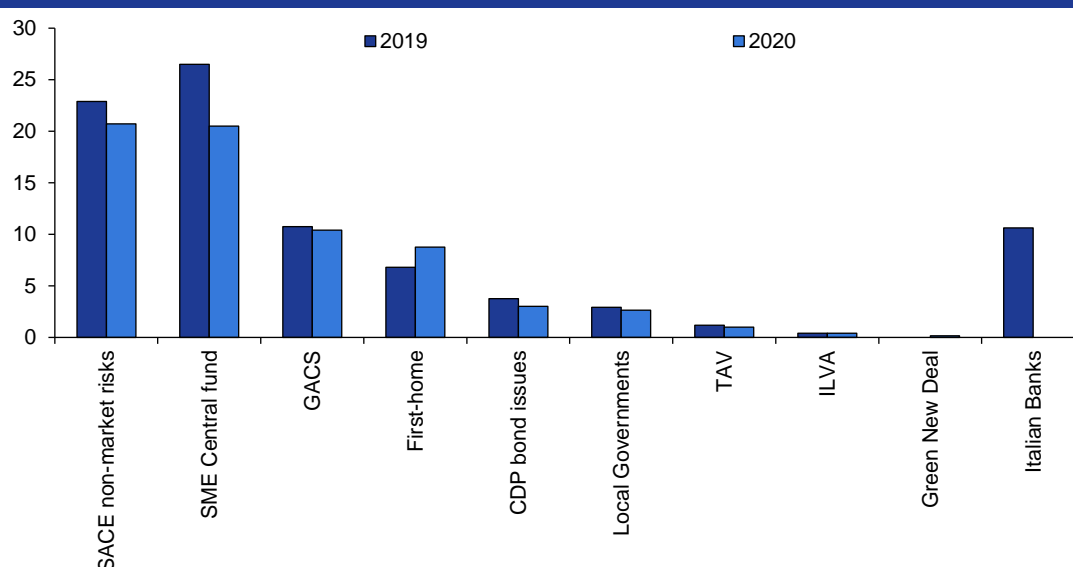
²⁸ Law Decree No. 35/2020.

Excluding the effect of these measures, the stock of guarantees not directly related to the Covid-19 crisis declined by about 0.7 percent of GDP in 2020 compared to 2019 (see figure III.3), reaching a level corresponding to 4.1 percent of GDP.

Almost all categories of guarantees declined, except those in favour of households for mortgages on first residences, which increased by € 2 billion compared to 2019, and the new Green New Deal guarantees introduced in July 2020, amounting to € 167 million.

In particular, the guarantees granted to the institutions of the financial sector, including banks, GACS²⁹ and those in favour of *Cassa Depositi e Prestiti*, amounted to € 13.4 billion (0.8 percent of GDP), and posted a reduction of € 11.7 billion compared to 2019. Among these, the residual debt on guarantees granted to Italian banks for liabilities on bonds issued by credit institutions is equal to zero.

FIGURE III.4: PUBLIC GUARANTEES NO-COVID IN 2019 AND 2020 (euro billion)



Note: The Fund for guarantee non-market risks in favour of SACE excludes the rebalancing effect, while the Central guarantee fund for SMEs includes only the share not related to the Covid-19 crisis.

Source: MEF elaboration.

In order to cover future calls of the guarantees, regulatory interventions have progressively raised the State budget earmarking to the guarantee funds, up to a total of € 46.2 billion³⁰.

The amount of contingent liabilities granted since the beginning of the Covid-19 crisis is large and implies a risk for the public finance, related to the possibility of defaults by the debtors. Nonetheless, since the increase derives from measures that are strictly related to the epidemic crisis, their impact is expected to fade as the economy recovers.

²⁹ The ‘*Garanzie sulla cartolarizzazione delle sofferenze*’ (GACS) cover the senior tranches of the securitized non-performing loans.

³⁰ Of which: EUR 15.2 billion for the Central Guarantee Fund for the SMEs; EUR 29.3 billion for *Garanzia Italia* and the ‘Market’ guarantees; 1.7 billion for the commercial credit insurance.

