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CENTRAL BANK AND THE EUROGROUP**

**2020 European Semester: Assessment of progress on structural reforms, prevention and  
correction of macroeconomic imbalances, and results of in-depth reviews under  
Regulation (EU) No 1176/2011**

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## EXECUTIVE SUMMARY

**Facing a weak macroeconomic outlook and the challenge of ensuring sustainability, lifting productivity and potential growth is key to reducing Italy's public debt ratio and unwinding its macroeconomic imbalances.** Implementing ambitious structural reforms and prudent fiscal policies, and well-targeting investments would support Italy's digital and environmental transformation, ensuring sustainable growth. As a matter of priority, a revived reform momentum should ensure sound public finances, more effective public administration and justice, a more efficient education system and labour market, a friendlier business environment and a more resilient banking sector <sup>(1)</sup>.

**Economic activity in Italy remains weak, despite a gradually improving labour market.** After real GDP growth of 0.8% in 2018, GDP expanded by 0.2% in 2019 and is expected to grow by 0.3% and 0.6% in 2020 and 2021. Domestic demand remains subdued, as real disposable income remains below pre-crisis levels and savings have risen. However, the new minimum income scheme introduced in 2019 and the sizeable drop in interest rates are expected to support household spending. Despite showing signs of recovery in 2019, public investment remains below pre-crisis levels. Sluggish productivity growth is still hindering Italy's economic recovery. A number of downside risks persist, especially concerning the international trading context and domestic stability. While the employment rate remains well below the EU average, particularly for women and young people, it continued to increase in 2019, driven by permanent contracts especially in the North. The unemployment rate declined to 9.8% in Q3-2019 from 10.3% a year earlier. However, wide gaps in employment rates remain between the country's regions.

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<sup>(1)</sup> This report assesses Italy's economy in light of the European Commission's Annual Sustainable Growth Strategy, published on 17 December 2019. In this document, the Commission sets out a new strategy on how to address not only the short-term economic challenges but also the economy's longer-term challenges. This new economic agenda of competitive sustainability rests on four dimensions: environmental sustainability, productivity gains, fairness, and macroeconomic stability.

**Italy has made some progress in addressing the 2019 country-specific recommendations<sup>(2)</sup>.**

There has been *substantial* progress in:

fighting tax evasion, including by strengthening the compulsory use of electronic payments.

There has been *some* progress in:

i) ensuring that active labour market and social policies are effectively integrated and reach out to vulnerable groups; ii) focusing investment-related economic policy on research and innovation and the quality of infrastructure; iii) making the public administration more effective; iv) fostering bank balance sheet restructuring; v) improving non-bank financing for smaller and innovative firms.

There has been *limited* progress in:

i) shifting taxation away from labour, reducing tax expenditure and reforming the cadastral system; ii) tackling undeclared work; iii) supporting women's participation in the labour market, through a comprehensive strategy; iv) improving educational outcomes, also through adequate and targeted investment, and fostering upskilling; v) reducing the length of civil trials, by enforcing and streamlining procedural rules; and vi) improving the effectiveness of the fight against corruption, by reforming procedural rules to reduce the length of criminal trials.

There has been *no* progress in:

i) reducing the share of old-age pensions in public spending and creating space for other social and growth-enhancing spending; and ii) addressing restrictions to competition, including through a new annual competition law.

**The Social Scoreboard supporting the European Pillar of Social Rights points to employment and social challenges.** Labour market conditions remain difficult. The unemployment rate is still high and employment and activity rates remain low, especially for women. Young people and the long-term

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<sup>(2)</sup> Information on the level of progress and actions taken to address the policy advice in each respective subpart of a country-specific recommendation is presented in the overview table in annex.

unemployed also face particular difficulties. The share of temporary contracts rose in past years, but job creation in 2019 was mainly driven by permanent contracts. Weak labour market conditions also impact social outcomes. While the risk of poverty and social exclusion is declining, income inequality increased in 2018. In-work poverty has been steadily rising and stabilised at high levels in 2018. Access to services such as childcare and healthcare is close to the EU average. However, it varies widely across regions.

Regarding the Europe 2020 strategy, Italy has already reached its targets on greenhouse gas emissions reduction, renewable energy, energy efficiency, early school leaving and tertiary education. Limited progress has been made in meeting the targets on the employment rate, R&D investment and poverty and social exclusion.

**Italy is making progress in achieving the United Nations' Sustainable Development Goals (SDG).** As confirmed by the progress in reaching its Europe 2020 targets (annex A), Italy achieved significant results in climate mitigation (SDG 13). By contrast, achieving SDG 4 (quality of education) will need further efforts in all related areas: basic education, tertiary education and adult learning <sup>(3)</sup>.

The main findings of the in-depth review and the related policy challenges are as follows:

**Italy's public debt remains an important source of vulnerability for the economy.** Italy's debt-to-GDP ratio reached 134.8% in 2018 and the Commission forecasts that it will further rise to 136.2% in 2019, 136.8% in 2020 and 137.4% in 2021, amid persistently weak nominal growth and a deteriorating primary balance. The Commission's debt sustainability analysis points to high risks in the medium and long term, due to the high level of debt and ageing costs. The recent pension reform will generate further costs up to 2028 and, if extended beyond its trial period, could

further erode potential growth and debt sustainability. In the short term, sustainability risks appear limited, also thanks to historically low sovereign yields since September 2019, but the need to rollover sizeable amounts of debt, at around 20% of GDP per year, still exposes Italy's public finances to sudden rises in financial markets' risk aversion. High debt-servicing costs also reduce the fiscal space to implement growth-enhancing and countercyclical policies.

**Productivity growth has been sluggish despite measures to support it.** The productivity gap between Italy and the EU continues to widen. In 2018, labour productivity declined by 0.3%, while in the euro area it grew by 0.5%. This is the result of declining labour productivity in southern regions and in services, as well as slower productivity growth in manufacturing compared to the euro area average. The effectiveness of recent measures to raise productivity growth, including incentives to invest and innovate, has been limited by delays in implementation, policy uncertainty and lack of a comprehensive strategy. More broadly, barriers to investment continue to constrain productivity dynamics and thus growth prospects, in turn hampering the reduction of the public debt-to-GDP ratio. Moreover, the weight of the informal economy in key economic sectors has a negative impact on their productivity.

**The unemployment rate remains high, although declining, and policies to raise labour market participation are yet to be fully implemented.** Slow economic growth, low average educational attainment, skill mismatches, and low activity rates, especially among women, limit employment growth. Youth unemployment remains extremely high. Moreover, the high share of involuntary part-time workers and discouraged workers suggests that labour market conditions remain weak. Strengthening active labour market policies is key for labour market reforms and the minimum income scheme to succeed. However, policies to increase people's skills and actively integrate jobless people in the labour market should be further developed

**The banking sector became more resilient, but pockets of vulnerability remain.** Italian banks continued to make progress in reducing non-performing loans, but the total stock is still high compared to euro area peers, especially for less

<sup>(3)</sup> Within the scope of its legal basis, the European Semester can help drive national economic and employment policies towards the achievement of the United Nations Sustainable Development Goals (SDGs) by monitoring progress and ensuring closer coordination of national efforts. The present report contains reinforced analysis and monitoring of the SDGs. A new annex (Annex E) presents a statistical assessment of trends in relation to SDGs in Italy during the past 5 years, based on Eurostat's EU SDG indicator set.

significant institutions. Following the recent fall in sovereign bonds yields, pressure on the capital and funding of Italian banks has subsided. However, bank exposure to domestic sovereign bonds remains high, therefore increasing the risk of it feeding back and spilling over to the real economy. The reform of the large cooperative banks has not yet been fully implemented, whereas the reform of small mutual banks has broadly been completed. The reform of the insolvency framework was adopted and is expected to be implemented by August 2020. Access to bank financing can be challenging, especially for smaller firms. Non-bank finance remains underdeveloped, in particular for small and innovative firms.

**A sustained budgetary-neutral public investment stimulus would substantially improve output and result in small but positive cross-border spillovers.** A simulation with the Commission's QUEST model suggests that an investment programme would have a sizeable effect on real GDP, improve its external position and lower its public debt ratio. However, the potential output effects are greatly dependent on the extent to which public investment is efficient.

Other key structural issues analysed in this report, which point to particular challenges for Italy are:

**The taxation of labour remains high and tax compliance low.** Italy's tax burden on labour is still among the highest in the EU, while value-added taxes are under-exploited, because of the large use of reduced rates. The 2020 budget reduced tax expenditures and the tax wedge on labour. A shift of the tax burden onto property and a revision of outdated cadastral values to bring them closer to market values have not taken place. Several measures have been enacted in recent years to encourage tax compliance, but tax evasion remains very high, especially in specific sectors.

**Challenges remain in the labour market.** Employment growth continues, though at a slower pace. The increase in the number of employees more than compensated for the decrease in the number of self-employed, while the shift from fixed-term to permanent contracts accelerated. The gender employment gap is among the highest in the EU and shows no sign of improving. Labour market slack and undeclared work remain serious concerns. In this context, real wages growth

remains close to zero. Collective bargaining at firm or local level continues to play only a limited role, while legislative initiatives on statutory minimum wages are under discussion. Active labour market policies continue to be implemented in the context of the new minimum income scheme, although at a relatively slow pace. Participation in adult learning is very limited, especially for low-skilled and underemployed workers, holding back firms' competitiveness and productivity growth.

**Education is a key challenge, especially in southern Italy, hindering the quality of skills.**

Italy has a much higher rate of early-school leavers and low achievers compared to the EU average, especially in the South. Shortages of secondary education teachers remain a challenge, as does attracting, selecting and motivating them. Compared to the EU average, the percentage of people having completed higher education remains low and the number of scientific/technical graduates is still insufficient. Higher education is underfinanced and understaffed. Despite better employability rates, vocational-oriented higher education is limited in scope. Shortages in basic and advanced digital skills are a serious concern. Measures to enhance vocational training are slowly being implemented. A comprehensive approach to upskilling, reskilling and adult learning is lacking.

**Social policies remain poorly integrated with other policies, including active labour market policies.**

While declining, the risk of poverty remains above the EU average, including for children and people with a migrant background. In-work poverty is also a challenge, especially for temporary workers. The southern regions and urban areas are the most affected. Limited access to quality social services increases the risk of poverty. Access to affordable and adequate housing remains a challenge, while the quality of the health services varies greatly across regions. In 2019, the citizenship income replaced the previous income support scheme to fight poverty, but more needs to be done to bring people to work. More efforts are needed to provide childcare and long-term care and promote equal opportunities and work-life balance. The lack of these affects women's participation in the labour market and the broad demographic trends, in a context of low birth rates and a reduced net migration rate.

**Productivity growth does not show signs of improving, despite positive investment trends.**

In the last two decades, Italy's labour productivity has stagnated, especially due to the poor performance of the services sector. Trends greatly differ depending on geographical area and firm size, particularly in manufacturing. A recovery of fixed investment could support productivity in the future. In this regard, higher levels of firms' digitisation, investments in research and innovation, a more efficient public sector and adequate skills are key. A comprehensive strategy to support productivity and investment is missing. Measures remain fragmented and temporary, not taking sufficient account of sectoral and geographical aspects.

**The business environment is improving, but strengthening Italy's public administration, justice system and anti-corruption framework remains a challenge.**

The digitisation of public services is progressing. Further efforts are needed to improve public employment, especially at management level. Weak administrative capacity is diminishing the public administration's ability to invest and carry out policy or enforcement tasks that affect businesses such as market surveillance. In this regard, a comprehensive strategy to strengthen it is missing. Inefficiencies in public procurement also remain often unaddressed. Despite recent improvements, the length of civil trials remains among the highest in the EU. Recent reforms are starting to bear fruit and an enabling law to streamline the civil procedure is under discussion. However, to reduce trial length, there is still ample room to ensure more efficient management of cases and limit unfounded appeals. The anti-corruption framework was strengthened recently, also through the anti-corruption law of January 2019. However, it needs to be completed. Indeed, no regulation sanctions conflict of interest for elected public officials, embezzlement in the private sector remains only partly criminalised, and provisions against lobbying do not apply to members of government and parliament. Moreover, the low efficiency of criminal justice in appeals continues preventing prosecuting corruption effectively. A reform of the criminal procedure and appeal system is still pending.

**Compliance with single market rules and the removal of barriers to competition would benefit several sectors, particularly services.**

Services are most affected by low enforcement of single market rules, with negative consequences for individuals and firms. They are also over-regulated, especially the retail sector, regulated professions and the collaborative economy. The lack of competitive processes to manage public services and limited authorisations for using public goods affects the quality and cost of services provided. The implementation of the 2015 Competition Law is delayed, and no new initiatives to address barriers to competition or improve sectoral regulation have been announced.

**The regional divide remains large and is widening.**

In the last decade, public spending decreased in the southern regions. The recent possibility for local governments to spend their surpluses without prior authorisation is having positive effects in municipalities with budgetary surpluses. Efforts to reduce the gap in private investment have been modest, especially for research and innovation where national policies actually widened the gap. Large disparities also remain in the quality of governance, the level of labour productivity and competitiveness. In this context, the high unemployment in the South leads to low and high skilled individuals migrating, worsening the local brain drain.

**Sustainability-related reforms and investment represent an opportunity for Italy.**

Italy performs above the EU average for resource productivity and investment in the circular economy. It is on track to reach its 2020 climate and energy targets, although more efforts are needed for longer-term goals. Implementing planned policies as laid out in the national energy and climate plan will be needed to reach the 2030 target for greenhouse gas emissions not covered by the EU emissions trading system. Transport emissions have increased strongly over the last five years and constitutes a key challenge for reaching the 2030 target. On the other hand, air quality, sustainable mobility, climate adaptation, prevention of hydrogeological and seismic risks, and water and waste management remain challenges.. Investing in environmental sustainability could be an opportunity for growth and high-skilled employment in the South.

The Commission's proposal for a **Just Transition Mechanism** under the next multi-annual financial framework for 2021-2027 includes a Just

Transition Fund, a dedicated scheme under InvestEU, and a new government loan facility with the EIB. It is designed to ensure that the transition towards EU climate neutrality is fair and could help the most affected regions in Italy to address the social and economic consequences. Key priorities for support by the Just Transition Fund, set up as part of the Just Transition Mechanism, are identified in Annex D, building on the analysis of the transition challenges outlined in this report.

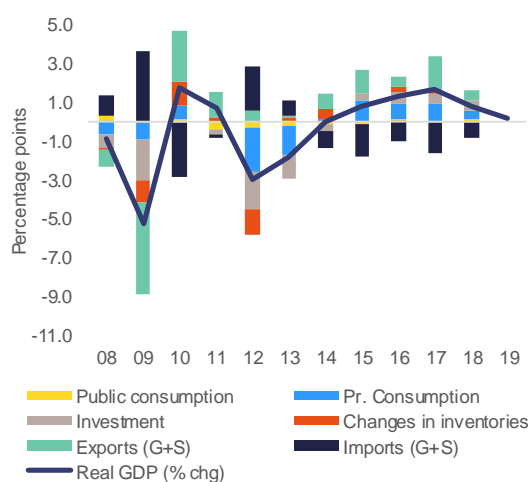


# 1. ECONOMIC SITUATION AND OUTLOOK

## Real GDP growth, prospects and risks

**Output growth has been feeble, as the economy remains stuck in low gear.** The Italian economy has been showing few signs of rebounding from its slowdown in 2018, when positive annual average GDP growth was exclusively due to a relatively strong carryover from the previous year. Economic activity slowed further in 2019, especially in the manufacturing sector, where firms trimmed inventories on a massive scale (Graph 1.1). This allowed firms to maintain their export activity, while reducing industrial output in view of lingering trade conflicts and related uncertainties over demand. The weakness in the manufacturing sector has also started spreading to the tertiary sector. Based on quarterly outturn data, real GDP grew by 0.2% in 2019 and is expected to expand by 0.3% and 0.6% in 2020 and 2021 respectively (European Commission, 2020).

Graph 1.1: Real GDP growth and components



Source: Eurostat

**A modest pick-up in domestic demand is set to support output growth in the near term.** In 2018, household consumption slowed down, in view of an economy at the margin of stagnation. The stagnating real disposable income weighs on consumer spending, which remained subdued in 2019<sup>(4)</sup>. In addition, households increased their precautionary savings amid weakening consumer

confidence. The impact of the slowing economy on the labour market and thus aggregate incomes is likely to be felt only with a lag. However, the new social benefits introduced in 2019 and targeted at low-income groups<sup>(5)</sup>, who tend to have a relatively large propensity to consume, are expected to lend some support to household spending. In addition, the sizeable drop in interest rates since September 2019 is likely to free up household resources, by reducing the servicing costs of mortgages and consumer loans, and hence to increase private consumption.

**Firms' profit margins have been falling, but favourable financing conditions are lending support to business investment.** Since the beginning of 2018, gross value added in the industrial sector has been shrinking and profitability in the corporate sector declining, hence affecting firms' self-financing capacity. Gross fixed capital formation, at 18.1% of GDP in Q3-2019, is still markedly below both the latest peak of 2007 (22%) and the EU average (20.6%). While spending on equipment is almost back to 2007 levels, investment in construction has only recently bottomed out. The share of intangible assets, albeit still low by EU standards, had increased to 2.9% of GDP by 2015 but has stagnated since then. The recovery of private investment is forecast to slow down sizeably, on the back of uncertain demand prospects. By contrast, public investment picked up in 2019, after 9 years of decline, and is expected to support aggregate capital spending.

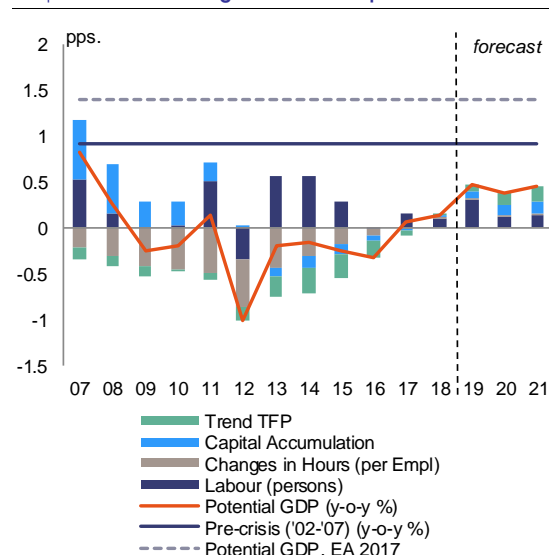
**Weak productivity growth, albeit varied across sectors, constrains economic expansion.** Labour productivity (real gross value added per hour worked) has been declining since Q2-2018, on the back of weak growth in gross value added. However, labour productivity differs across sectors, with manufacturing and some parts of the service sector registering a noticeable rise in real output per hour worked. Overall, the productivity gap between Italy and the rest of the EU remains pronounced and is widening. Labour productivity in Italy rose on average by 0.5% per year between 2010 and 2018, compared with an EU average of 1.3%.

<sup>(4)</sup> Spending on some consumer items, in particular food, clothing and transport, declined in the first half of 2019 compared to the first half of 2018.

<sup>(5)</sup> The new minimum income scheme (*Reddito di cittadinanza*) was introduced in April 2019 (see also Section 4.3).

**Potential growth is estimated to have picked up moderately in 2019.** Potential output declined between 2009 and 2016 due to the negative contributions from labour and total factor productivity (TFP). Supported by rising labour input, growth in potential output is estimated to have turned slightly positive in 2017 and is projected at 0.5% in 2019-2021 (Graph 1.2), sizeably below the EU average (1.6%). Trend TFP growth is estimated to have resumed in 2018 and begun making a positive contribution (Graph 1.2).

Graph 1.2: Potential growth and components



Source: European Commission.

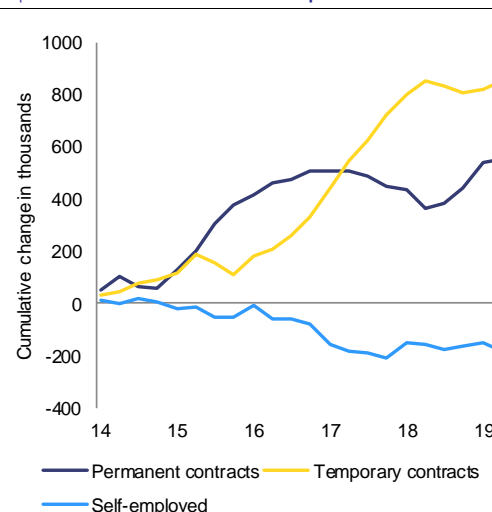
**The balance of risks to the growth outlook remains skewed to the downside.** As a large exporter, Italy is particularly exposed to the global economy. The latter remains prone to further policy-related shocks caused by, among other factors, trade conflicts, as well as structural shifts in the global manufacturing sector. Also, concerns about future fiscal policy might dent confidence and partly reverse the recent sovereign yield compression. On the upside, easing trade tensions and stronger-than-expected pick-up in global growth would benefit investment and exports.

### Labour market

**In the first 9 months of 2019, employment grew despite an almost stagnating economy.** Between Q3-2018 and Q3-2019, headcount employment grew by 0.6%, driven by the rise of permanent

employees (Graph 1.3).<sup>(6)</sup> By contrast, the level of self-employed declined in the same period, while temporary employment remained broadly constant. Employment has been increasing since end-2013, and the employment rate rose to 63.6% in Q3-2019, while the unemployment rate fell to 9.8%, despite a slight drop in the labour force. The average duration of unemployment increased to 27 months, and the share of long-term unemployment over total unemployment rose to 59%, well above the EU average (43.5%). Youth unemployment is slowly falling (28.3% in Q3-2019) but remains one of the highest in the EU, as does the number of young people not in employment, education or training (19.2% in 2018).

Graph 1.3: Labour market developments



Source: Istat.

**Employment growth has been concentrated in labour-intensive sectors with low value-added.** Most of the 151,200 additional headcount employment registered between Q3-2018 and Q3-2019 was generated in the service sector, mostly administrative and support services, household care and repair, and personal care, and in northern regions. As jobs tend to be created mostly in relatively less productive sectors, employment shifts tend to have a negative impact on aggregate productivity and average wages.

<sup>(6)</sup> The growth in permanent positions is also driven by the fact that more temporary posts are being turned into permanent posts because of recent legislative changes (*Dignity Decree*), see also Section 4.3.

**Stagnating labour productivity bodes ill for future employment growth.** Gross value added in the manufacturing sector has been declining since early 2018, implying a contraction of labour productivity, while the drop in productivity in the services sector was less pronounced. In addition, the number of hours authorised under the Italian short time working scheme (*Cassa Integrazione Guadagni*) <sup>(7)</sup> has increased since the end of 2018, potentially leading to future reductions in employment in the industrial sector.

**Slack in the labour market remains considerable.** Hours worked and employment (expressed in full-time equivalents) are still below the 2007 levels. The increase in total hours worked in the first three quarters of 2019 (0.5%) was largely driven by the growth in additional positions. Since 2010, part-time work has been an important driver of job creation. In the first three quarters of 2019, part-time work increased on average by 2.5% compared to the same period of 2018, while the number of full-time positions remained broadly unchanged. Moreover, involuntary part-time remains widespread, and the pool of discouraged workers is around three million people. The increase in involuntary part-time and temporary employment has been particularly marked in the South.

### Wages, prices and costs

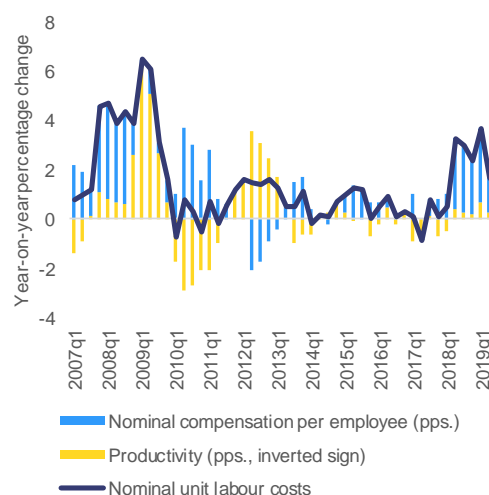
**Wages continue to grow at a moderate pace.** In 2019, hourly negotiated wages grew by 1.0% on average, driven by increases in the public sector (1.8%). By contrast wages in the private sector grew by 0.8%, where contract renewals are still pending for around 29.4% of employees) <sup>(8)</sup>. In the fourth quarter of 2019, nominal compensation per employee increased by 0.7% year-on-year, and real compensation by 0.5%.

<sup>(7)</sup> The *Cassa Integrazione Guadagni* (CIG) supplements wages for employees affected by temporary layoffs (who are not considered unemployed), or under a forced reduction of working hours. The recent increase is driven by the extraordinary CIG component (*Cassa Integrazione Guadagni Straordinaria*), which is activated in case of business crises and restructuring.

<sup>(8)</sup> In December 2019, along with a slowdown in the pace of growth of negotiated wages, the share of employees with negotiations ongoing on the renewal of national sectoral collective contracts stood at 46%. It has been on average 16 months since national contracts, for which renewal negotiations are still pending, expired.

**Growth in unit labour costs slightly accelerated in 2018.** With the beginning of the slowdown in the manufacturing sector, aggregate unit labour costs started to rise. This is because labour productivity declined in 2018-2019 (-0.1%)(Graph 1.4) and labour costs increased, due to the moderately increasing nominal wage growth and the end of the exemption from social contributions of a rising share of labour contracts <sup>(9)</sup>. Wage growth is broadly in line with what could be expected based on productivity developments, prices and the unemployment rate.

Graph 1.4: Wages, labour costs and productivity



Source: Istat.

**Moderate domestic demand and subdued wage growth suggest only a gradual rise in core inflation.** Consumer price inflation (harmonised index of consumer prices - HICP) slowed down to 0.6% in 2019, from 1.2% in 2018. HICP inflation is expected to increase to 1.0% by 2021. Annual HICP core inflation (i.e. excluding unprocessed food and energy) stood at 0.6% in 2019 and is set to gradually pick up, in line with moderate wage growth and the recovery of profit margins. The growth rate of the GDP deflator, on a downward trend since 2010 due to subdued demand and only moderate growth in unit labour costs, is projected to have fallen to 0.6% in 2019 but is forecast to rise to 1.1% by 2021.

<sup>(9)</sup> The Jobs Act labour market reform adopted in end-2014 included temporary incentives for companies that hired permanent workers on new, less-protected terms in the form of a three-year exemption from social contributions.

### Inequality and poverty risk

**Income inequality is among the highest in the EU.** The Gini coefficient (of equalised disposable income), already one of the highest in the EU, rose further in 2018, indicating a more uneven distribution of incomes. The tax-and-benefit system, albeit among the least effective in the EU, is mitigating the unequal distribution of market incomes but largely to the benefit of pensioners. The large weight of pensions in social expenditure is reflected in lower income inequality among the elderly. In 2018, the ratio of the total income received by the 20% of the population with the highest income to that received by the 20% with the lowest income stood at 6.55 for persons under 65 years old, but only at 4.86 for persons aged 65 or above.

**The risk of poverty is declining, but in-work poverty remains high.** Helped by solid employment growth in recent years, the risk of poverty and social exclusion declined to 27.3% in 2018, down from its peak of 30% in 2016. Yet, it remains sizeably above the EU average (21.7%) and above the level registered in 2007 (26%), while regional disparities loom large. By contrast, the rate for those in work who are at-risk of poverty has trended upwards since 2010 and reached 12.3% in 2018, almost 3 percentage points above the EU average. Key reasons are that, despite an improving overall labour market situation, the share of (involuntary) part-time employment has increased, and wage growth has remained subdued. As a result, real gross disposable income was almost 10% lower in 2018 than in 2007 <sup>(10)</sup>.

### Financial developments

**Government bond yields have fallen sharply on the back of declining sovereign risk premiums.** Currently, yields for Italian sovereign bonds are well below the peak levels observed in 2018. Political uncertainty has gradually abated, financial tensions eased and market conditions improved. This was supported by both the ECB's return to a more expansionary monetary policy stance <sup>(11)</sup> and

the Italian government's decisions to make adjustments to their fiscal targets. The sovereign risk premium on Italian government securities, as measured by credit default swaps (CDS), has declined but is still higher than at the beginning of 2018 (Bank of Italy, 2019a) <sup>(12)</sup>. Vulnerabilities remain as regards the debt rollover risks. The ten-year sovereign bond yield dropped from 2.7% at the beginning of 2019 to below 1% end-August but has again risen above 1.3% by mid-January 2020. The spread vis-à-vis German bonds narrowed by almost 100 basis points over the same period but is still wider than the one for Spanish or Portuguese bonds. The yields on Italian sovereign bonds with maturities of up to 2 years turned negative in summer 2019 and were close to zero in mid-January 2020. In 2019, rating agencies kept Italy's credit rating stable and the outlook unchanged. <sup>(13)</sup>

**The sharp decline in long-term interest rates buoyed share and corporate bond prices.** Amid pronounced volatility on global stock markets due to the weakening global outlook and heightened trade policy risks, Italian equity prices gained substantially in 2019. The Milan benchmark stock exchange index increased by 30% between end-2018 and mid-January 2020, with the bank sub-index rising about 22%. Following the reduction in Italy's sovereign yields, the risk premiums on the two main Italian banking groups, as measured by CDS spreads, have declined and are only slightly higher than the average of the other large European banks. However, the price-to-book ratio of Italian listed banks, a standard metric to gauge their economic value, is below unity and lower than for other European banks', indicating subdued earnings expectations and elevated risk premiums demanded by investors.

**Since early 2019, foreign investors have again increased their exposure to Italian assets.** After the sharp sell-offs in the second half of 2018, non-

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announcement made at the ECB Forum on Central Banking held in June 2019.

<sup>(12)</sup> The gap between the premium on CDS contracts that offer protection against redenomination risk and that on contracts with no such provision (ISDA basis) has narrowed to levels only a little higher than in the first months of 2018, although the spread compared with other euro area countries remains sizeable (see Bank of Italy, 2019a, p. 24f.).

<sup>(13)</sup> Moody's rates Italy at Baa3 (BBB-), one notch above investment grade, while Standard & Poor's left its rating unchanged at BBB on 25 October 2019, but kept its outlook at 'negative'.

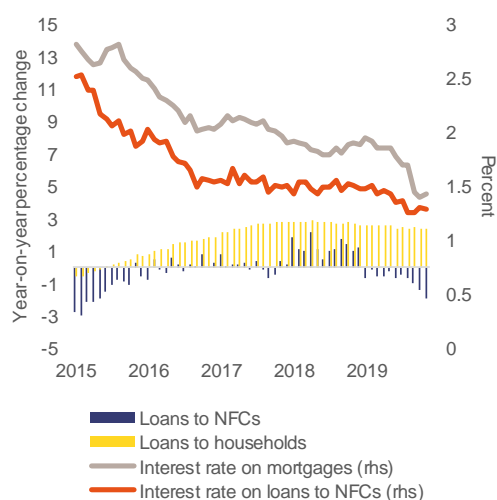
<sup>(10)</sup> See also Section 4.3.2.

<sup>(11)</sup> In September 2019, the ECB Governing Council adopted a broad package of expansionary measures (ECB, 2019). The effect was already visible in summer due to the

resident investors raised their portfolio of Italian government securities by €90 billion until November 2019. In the same period, foreign holdings of bank bonds rose by €9.9 billion. Deposits placed with Italian banks remained stable, and private sector deposits rose by 7.6% in November 2019 compared to the same month of 2018. Since May 2018, deposits from domestic households and non-financial corporations have overall slightly increased.

**Lending to households is rising at a moderate pace, while lending to firms is decreasing.** The growth of lending to households slowed down slightly over 2019, but is still solid for house purchases and consumer credit. On average, loans to the non-financial corporate sector continue to decrease on an annual basis, albeit with large variations across risk classes (Graph 1.5).

Graph 1.5: **Lending volumes and interest rates, private sector**



(1) Interest rates for new businesses.

Source: Bank of Italy.

**The contraction in lending is concentrated among the riskiest firms.** By contrast, lending continues to grow for financially sound larger firms (Bank of Italy, 2019a). The cost of new loans, which has been decreasing in recent months, is at historically low levels. Bank lending surveys indicate an easing of credit conditions for firms and households. Meanwhile, credit demand from companies has declined, given firms' reduced need to finance fixed capital formation or inventories and working capital.

**Financial conditions are stable but remain vulnerable to adverse cyclical conditions.** Firms' profitability is weakening, but debt repayment capacity remains strong thanks to low interest rates and sounder balance sheet structures than in the past. Moreover, the high average residual maturity of Italy's public debt slows down the transmission of an increase in government yields to the average cost of debt. However, a marked economic slowdown and higher interest rates in light of high public debt could expose financial vulnerabilities.

### External position

**Italy's current account surplus rose in 2019 due to an increasing goods balance.** Despite the slowdown in global trade, export growth remained stable and exporting firms broadly maintained market shares. By contrast, imports decelerated sharply, owing to a negative inventory cycle. As a result, the current account balance registered a surplus of 2.9% in the 12-month period up to November 2019 (Graph 1.6). Savings and investment decisions at sector level determine current account fluctuations. Since 2009, the corporate sector, traditionally in a debtor position, has acted as net lender to the economy and its net lending position widened to 0.8% of GDP in 2018. By contrast, households reduced net lending from 2.3% of GDP in 2014 to 1.3% of GDP in 2018.

**The cyclically adjusted current account surplus is estimated at 2.7% of GDP in 2019.** This surplus is estimated to be sufficient to keep Italy's net international investment position (NIIP) stable and bring it closer to the level that fundamentals suggest (in the absence of valuation effects) <sup>(14)</sup>.

**The NIIP is almost balanced.** Since the low point in early 2014, Italy's NIIP improved by €351 billion. As a result, the stock of net external liabilities fell to €55.3 billion (or 3.1% of 2018 GDP) by Q3-2019. That positive trend was helped by persistent current account surpluses and supported by valuation effects.

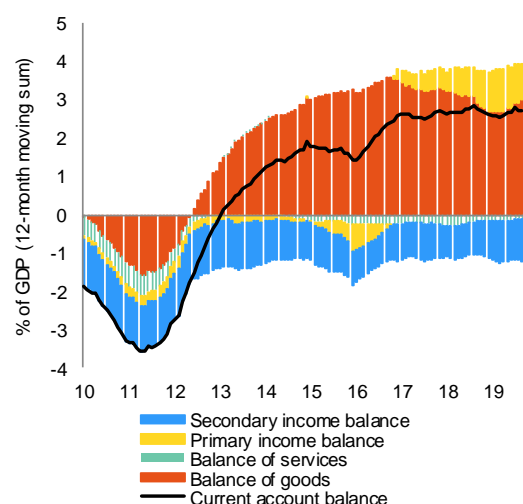
**In 2019, the TARGET2 balance improved.** In December 2019, the Bank of Italy's net debtor position in the TARGET2 European payment

<sup>(14)</sup> For details regarding the estimation of current accounts based on fundamentals, see Coutinho, L. et al. (2018).



system stood at €439 billion, down from the €493 billion in August 2018.

Graph 1.6: Current account balance



Source: Bank of Italy.

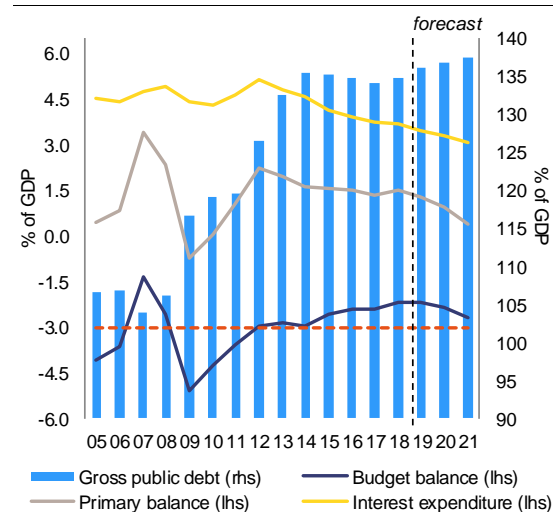
### Public finances: public deficit and debt

**The government headline deficit is expected to remain broadly stable in 2019 and 2020, leading to a worsening primary balance.** After slightly declining from 2.4% of GDP in 2017 to 2.2% of GDP in 2018, the government deficit is projected to have remained stable in 2019 and to marginally increase to 2.3% of GDP in 2020, based on the Commission 2019 Autumn Forecast. The new minimum income and early retirement schemes will lead to a large increase of public spending over 2019-2020, which will only partially be compensated by measures on the revenue side. In 2021, under a no-policy-change assumption (in particular, not considering the increase in VAT legislated as a safeguard clause), the headline deficit is expected to increase to 2.7% of GDP. Given the projected reduction of interest spending (from 3.7% of GDP in 2018 to 3.1% of GDP in 2021), the government primary surplus is expected to decline from 1.5% of GDP in 2018 to 0.4% of GDP in 2021 (Graph 1.7). The structural balance is projected to improve from -2.4% of GDP in 2018 to -2.2% in 2019, and to deteriorate to -2.5% and -2.9% of GDP in 2020 and 2021 respectively.

**The government debt-to-GDP ratio is expected to continue growing until 2021.** In September 2019, Italy's national statistical institute (ISTAT)

and the Bank of Italy published revised data on the country's public debt, which implied an upward level shift over the recent years. Following the revision, Italy's debt-to-GDP ratio peaked at 135.4% in 2014, before declining to 134.1% in 2017 and rising again to 134.8% in 2018. The increase in 2018 was due to particularly low real GDP growth and a large stock-flow adjustment (0.7% of GDP), mainly related to fluctuations of the Treasury liquidity reserves and negative developments in the financial markets. The Commission 2019 Autumn Forecast expects Italy's debt-to-GDP ratio to further rise to 136.2% in 2019, 136.8% in 2020 and 137.5% in 2021, amid persistently weak nominal GDP growth and a deteriorating primary balance (see Section 4.1). Given the track record of recent years, those projections do not consider any proceeds from privatisations, although the government is targeting 0.2% of GDP per year over 2020-2022.

Graph 1.7: Public finances indicators



Source: European Commission

**Italy is making progress in achieving the United Nations' Sustainable Development goals.** Over the past 5 years, progress has been relevant in most of the UN Sustainable Development Goals (SDGs), particularly for SDGs 3 (good health and well-being), 7 (affordable and clean energy), 12 (responsible consumption and production) and 16 (peace, justice and strong institutions). By contrast, SDGs 1 (no poverty), 10 (reduce inequalities) and 15 (life on land) present a mixed picture, with some indexes worsening in the short run. Overall, Italy underperforms the EU average in most of the

indexes related to SDGs 4 (quality of education), 5 (gender equality), 8 (economic growth) while it performs better than average on SDGs 6 (clean water and sanitation), 11 (sustainable cities) and 12 (responsible consumption). In this context, Italy's initiative on well-being indicators (based on the well-being evaluation scale - WES) and on SDGs at national and regional level (ISTAT, 2019i) is a European best practice supported by civil society organisations (see ASVIS, 2019). In particular, the former indicators include, together with social indicators on poverty, inequality and gender balance, indicators on the level of CO2 emissions as well as a proxy for soil erosion. Regarding the latter, by summer 2020 Italy's regions and autonomous provinces are to have approved their own sustainable development strategies for 2017-2030.