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COMMISSION STAFF WORKING DOCUMENT

In-Depth Review for Italy

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

Accompanying the

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

Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy

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EXECUTIVE SUMMARY

The 2021 Alert Mechanism Report concluded that an in-depth review should be undertaken for Italy to examine further the persistence of imbalances or their unwinding. In February 2020, under the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified “excessive macroeconomic imbalances” in Italy. These imbalances related to high government debt and protracted weak productivity dynamics in a context of high unemployment and a still high level of non-performing loans, albeit with a decreasing trend. The analysis shows that these vulnerabilities remain. It should be noted that the context of the assessment of vulnerabilities in this year’s in-depth review (IDR) for Italy is markedly different from last year. Also, the evolution of the COVID-19 pandemic, the strength of the recovery, and possible structural implications of the crisis are all still surrounded by high uncertainty, requiring caution in the assessment. In general, policy action over the past year focused on cushioning the impact of the COVID-19 shock and facilitating the recovery. This has added to indebtedness but should support adjustment in the medium-term. Looking forward, the Recovery and Resilience Plan provides an opportunity to address imbalances, investment and reforms needs.

Main observations and findings of this IDR analysis are:

- **This IDR is informed by the 2021 spring forecast, which expects a recovery in economic activity in Italy with the easing of the COVID-19 crisis.** After the steep drop of 8.9% in 2020, real GDP is projected to increase by 4.2% this year and 4.4% next year, reaching the pre-pandemic level of economic activity by the end of 2022.

- **Italy’s high government debt-to-GDP ratio sharply increased to 155.8% in 2020 and is projected to rise further in 2021, before declining in 2022.** The increase in 2020 was driven by the drop in GDP and the measures taken to address the COVID-19 crisis and to support the economy. In 2021, the prolonged fiscal support needed in light of the duration of the pandemic is expected to cause a further increase in government debt to 159.8% of GDP, despite the projected economic growth. In 2022, the debt ratio is expected to decline to 156.6% of GDP thanks to the economic recovery and the improving primary balance. In the short term, the pace of decline of the debt-to-GDP ratio will depend on the strength of the economic recovery and the national fiscal stance. In the longer term, effective reforms supporting potential growth as well as prudent fiscal policies will be crucial.

- **Higher potential growth is essential for a faster reduction in the government debt-to-GDP ratio.** Potential growth, historically low for over a decade, is forecast to rise to 0.9% by 2022. Labour productivity registered a sizeable increase in 2020, as the drop in hours worked exceeded the fall in economic output, but long-term productivity growth remains constrained by barriers to investment in the private and public sectors, and a limited reallocation of resources to the most productive firms.

- **While the Italian banking sector has strengthened since the double-dip recession in 2008-2013, vulnerabilities remain.** Italian banks further reduced their legacy stock of non-performing loans (NPLs) to a gross ratio of 5.7% in the third quarter of 2020. However, the NPLs ratio still stands well above the euro area average of 2.7% and is likely to increase once support measures are phased out. Bank lending volumes have increased markedly throughout the pandemic, predominantly driven by public guarantees to meet firms’ greater liquidity needs, to avert a credit crunch and corporate insolvencies. The phasing-out of support measures can induce a tightening of the credit conditions, restriction of credit supply and deterioration of banks’ asset quality.

- **Employment dropped sizeably since the onset of the COVID-19 crisis, but the unemployment rate declined in 2020, as a large number of persons exited the labour market.** Employees on fixed-term contracts and the self-employed bore the brunt of the COVID-19 shock, even though strong government support mitigated the overall impact of the crisis on the labour market. However, the unemployment rate is forecast to increase in 2021 and to stay at elevated levels in 2022, as an increasing labour force is set to at least partly offset employment gains. Activity and employment rates, in particular of women and young people, remain markedly below the EU average.

1. ASSESSMENT OF MACROECONOMIC IMBALANCES

Introduction

In February 2020, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure, the Commission identified "excessive macroeconomic imbalances" in Italy. These excessive imbalances related to high government debt and protracted weak productivity dynamics, which also imply risks with cross-border relevance, in a context of high unemployment and a still high level of non-performing loans. The 2021 Alert Mechanism Report published in November 2020 concluded that a new in-depth review (IDR) should be undertaken for Italy with a view to assess the persistence or unwinding of imbalances.

The context of the assessment of vulnerabilities this year is markedly different from last year's IDRs, which took place before the COVID-19 pandemic. The evolution of the pandemic, the strength of the recovery, and possible structural implications of the crisis are still surrounded by high uncertainty requiring caution in the assessment. Policy action over the past year focused on cushioning the impact of the COVID-19 shock and on facilitating the recovery. While this supports adjustment in the medium-term through stronger fundamentals, it also has added to indebtedness. Follow-up to country-specific recommendations from 2019 and 2020, including those that are MIP-relevant, is taking place in the context of the assessment of the Recovery and Resilience Plans (RRPs). The analysis of policies in the present report was finalised before the formal submission of RRPs and does not draw on information included in RRPs. It is therefore without prejudice to the Commission's assessment of RRPs, which is ongoing at the time of publication of this report.

The key features of the IDR remain unchanged. The assessment follows a similar structure as the IDRs that were included in Country Reports in recent annual cycles. This chapter presents the main findings for the assessment of imbalances, also summarised in the MIP assessment matrix. The assessment is backed by selected thematic chapters that look more at length at public debt, the labour market and the financial sector. Spillovers and systemic cross-border implications of imbalances are also taken into account. In addition, also assessments of structural issues made in previous IDRs and in the context of fiscal assessments are considered if relevant.

Macroeconomic context

Real GDP growth is forecast to rebound once containment measures are markedly eased, allowing the economy to recover its pre-pandemic level by the end of 2022. The vaccination campaign and the easing of restrictions are paving the way for a strong rebound of Italy's economy in the second half of 2021. EU-supported investment is set to help lift the economy to a sustained expansion path, which is likely to allow output to recover its pre-pandemic level by end-2022. After the steep drop of 8.9% in 2020, real GDP is projected to rebound by 4.2% this year on the back of sizeable domestic policy support and the first stage of NGEU-financed investment. In 2022, output growth is forecast to increase to 4.4%. Potential growth, historically low for over a decade, is forecast to rise to 0.9% by 2022. The output gap is set to shrink but remain negative, at -1.4% in 2022. In view of the projected domestic demand-led expansion, the current account balance is forecast to gradually decline, to a surplus of about 3% of GDP in 2022, somewhat below the surplus registered in 2019 (3.2%). The unemployment rate is projected to rise to 10.2% in 2021, before falling again below 10% in 2022, as the recovery gains traction. Base effects related to rising oil prices are likely to push HICP inflation above 1% this year, before consumer price inflation moderates to about 1.1% in 2022.

The economic recovery is expected to be driven by pent-up consumer demand and EU-supported investment. Buoyant consumer demand will help the economy bounce back, once containment measures are relaxed. However, the household saving rate is unlikely to return to its long-run average by the end of the forecast period. Persisting uncertainty and the concentration of forced excess savings among higher-income households with a relatively low propensity to consume suggests that the additional impulse from savings-fuelled consumer spending will be limited. Capital spending is forecast to pick up vigorously, as RRF-financed expenditure is set to spur corporate investment as well as residential investment. Goods exports continue to benefit from a strong momentum thanks to an improving external outlook, allowing exporters to regain some previously lost market share. However, services exports, in particular tourism, are unlikely to fully recover by 2022. The outlook remains subject to high uncertainty and pandemic-related downside risks, also related to potential scarring effects due to corporate insolvencies and hysteresis in the labour market.

Imbalances and their gravity

The very high government debt is an important source of vulnerability for the economy. The growing share of government securities held by the Eurosystem, the low interest rate environment and the growing average maturity of the outstanding debt substantially reduce financial sustainability risks in the short term. However, the high financing requirements related to debt rollover needs increase Italy's dependency on financial market risk perceptions. The high government debt also reduces margins to take support measures in case of future crises, and the sizeable interest expenditure reduces fiscal space for growth-enhancing expenditure. The Commission's debt sustainability analysis points to high risks in the medium term, which are mainly related to the high stock of government debt. In the long term, the high debt ratio is expected to pose medium fiscal sustainability risks, thanks to projected ageing costs which, after increasing in the coming years, are set to progressively decline.

Insufficient investment, the high share of low-productivity sectors in the Italian economy and the small average firm size are among the main reasons for subdued productivity growth. Labour productivity growth has remained very low in Italy during the last decade, also on account of the higher share of activities with lower productivity levels. In 2020, labour productivity measured as gross value added per hour worked increased, as the GDP contraction exceeded the drop in hours worked. With the expected increase in hours worked as the recovery unfolds, labour productivity growth is set to fall back to the low rates registered in the previous decade. The large share of small enterprises hampers overall higher productivity levels and growth in Italy, particularly for trade activities, food and accommodation services. Italy is among the lagging countries in terms of intangible investment, also explained by the large weight of industries with low intangible capital intensity like tourism. It has substantially lower R&D intensity than its peers in the EU. However, ICT services have registered rising productivity over time. Moreover, pandemic-induced changes to operational processes and further investment in IT equipment and process innovation have the potential to translate into more sustained productivity improvements going forward. Finally, productivity growth has an important bearing on potential output and easing the burden of public debt (debt deleveraging).

Employment dropped sizeably since the onset of the COVID-19 crisis, but the unemployment rate declined in 2020, as a large number of persons exited the labour market. Total headcount employment shrunk by 2.8% in 2020, with employees on fixed term contracts (-12.1%) and the self-employed (-4.1%) bearing the brunt of the COVID-19 pandemic shock. However, the average unemployment rate in 2020 dropped below the level of 2019 (9.2% vs. an average of 10.0% in 2019). Many job seekers and newly unemployed left the labour force at the peak of the pandemic, while most employees were supported by short-time work schemes in combination with a general dismissal ban. By contrast, the jobless rate of young people (15-24 yrs), who were often employed in contact-intensive services on short-term contracts and were thus particularly affected by the crisis slightly increased in 2020 compared to 2019 and stood at 29.5% (vs. 29.2% in 2019), among the highest in the EU.

While the Italian banking sector has strengthened since the double-dip recession in 2008-2013, vulnerabilities remain and need close oversight in light of the current developments. Italian banks further reduced their legacy stock of non-performing loans (NPLs) to a gross ratio of 5.7 % ([1]) in the third quarter of 2020 compared to a level of 7.4% during the same period of the previous year. However, the NPL ratio still stands well above the euro area average of 2.7% and is likely to increase on the back of the economic downturn. Throughout the COVID-19 pandemic, bank loans have increased markedly, driven mainly by public guarantees to meet firms' greater liquidity needs but also for precautionary reasons. The phasing-out of support measures, such as loan moratoria and state-guaranteed loans, can be expected to induce

([1]) ECB data.

tightening of the credit conditions, restriction of credit supply and deterioration of banks' asset quality. This would in turn put further strain on the subdued profitability of banks, impacted already by the increase in loan-loss provisions and low interest rates. The sovereign-bank nexus has recently increased in Italy and warrants further monitoring once support and regulatory relief measures are gradually phased out.

The Italian economy can have spill-over effects on other EU Member States. This is due to its relatively large size and its level of integration with other Member States either via trade links, such as Slovenia and financial and/or banking linkages, such as Luxembourg (see Table 1.1). Box 1.1 provides a quantitative assessment of cross-border impact of declined Italian demand in 2020. It shows a rather heterogeneous impact across the Member States, with Slovenia and Croatia being the most adversely affected. The most important spillover are indirect ones, i.e. via supply chains.

Table 1.1: **Outward spillovers heat map, Italy**

	EU partner																										
	AT	BE	BG	HR	CY	CZ	DE	DK	EE	EL	ES	FI	FR	HU	IE	IT	LT	LU	LV	MT	NL	PL	PT	RO	SE	SI	SK
Imports	3.4	5.1	4.2	4.1	0.1	3.4	2.4	1.2	0.8	2.8	2.4	0.8	2.1	4.5	2.9		1.9	15.2	1.1	2.6	3.9	2.3	1.6	3.7	1.1	11.8	5.5
Imports (in value added)	1.8	1.66	2.2	2.38	0.62	1.65	1.21	0.73	0.58	1.15	1.27	0.53	1.18	2.08	2.72		1.16	4.4	0.6	1.67	1.33	1.37	0.79	2.24	0.74	4.48	2.06
Financial liabilities	8.6	10.5	3.3	2.2	5.4	0.7	7.1	2.8	1.7	5.7	15	2.6	23.3	3.2	50.5		1.1	541	2.8	12.7	17.9	0.6	13.5	1.7	2.1	5	3.1
Financial assets	8.6	6.7	6.6	11.1	7.5	4.8	4.7	1.8	0.5	10.2	12.8	2.8	11.3	3.3	65.8		0.6	1088.6	3.2	7.8	18.8	2.8	8.4	7	1.8	8.3	2.9
Liabilities (to banks)	1.3	1					2.5			3.5	7.7		14.2		0.1						2.9	4.8			0		
Bank claims	24.3	2		48.5	2.67	13.4	5.9	0.6	0.9	0.5	7.2	0.9	2.66	11.3	4.1		1.1	42.7	1.3		2.87	0.8	3.5	5.4	0.4	12.5	25.9

Note: Cross-border figures for Italy, expressed as a % of the GDP of the partner country. The darkest shade of red corresponds to percentile 95 and the darkest shade of green to percentile 5. The percentiles were calculated for each variable based on the full available sample of bilateral exposures among EU countries. The blank spaces represent missing data. Data refer to: Imports - 2018, Imports (in value added) - 2015, Financial liabilities - 2018, Financial assets - 2018, Liabilities (to banks) - 2020-Q3, Bank Claims - 2020-Q3.
Source: IMF, OECD, TiVa, BIS and Commission services

Evolution, prospects and policy responses

Italy's debt-to-GDP ratio sharply increased to 155.8% in 2020 and is projected to rise moderately further in 2021, before declining in 2022. The increase in 2020 was driven by the drop in GDP and the cost of the policy response to the COVID-19 crisis, which caused the primary balance to turn negative for the first time since 2009. In 2021, the cost of the prolonged policy support related to the duration of the COVID-19 pandemic is expected to cause a further increase of the debt-to-GDP ratio to 159.8% due to the sizeable primary deficit, despite the projected GDP growth well above potential growth. In particular, two additional fiscal packages, adopted in March and May 2021 and worth 1.8% and 2.3% of GDP respectively, further extended emergency wage supplementation schemes and provided additional support to the corporate sector. In 2022, the debt ratio is expected to decline to 156.6% of GDP thanks to the economic recovery, while the debt-increasing impact of the primary deficit is set to become smaller. After some volatility observed in March and April 2020, sovereign yields and risk premia declined substantially in the course of the year, also supported by the ECB policy. After being on a declining trend for several years, expenditure for public investment increased strongly in 2019, albeit from a low base, and continued rising in 2020 despite the COVID-19 pandemic, thanks to the higher resources allocated and more flexible fiscal provisions for local governments. Pension expenditure increased substantially in 2019 and 2020, due to demographic developments and the temporary early retirement scheme implemented in 2019, and is projected to continue growing at a significant rate in the coming years based on a no-policy-change assumption. The tax system remains characterised by several longstanding weaknesses, including the high tax burden on labour and tax evasion. The government plans to adopt a comprehensive review of personal income taxes, whose details are however not yet known. Estimated revenue losses from tax evasion remain very high, but they started declining in 2018 and are expected to have remained on this trend in 2019 thanks to the important measures taken in that year. ([2])

During the period 2010-19, productivity growth averaged 0.4% per year (EU: 1.2%). In 2019, growth in gross value added stagnated, as a rising labour and capital input was offset by falling total

([2]) Official government estimates on the revenue loss from tax evasion are published yearly in an annex to the "Update of the document of economy and finance" ("*Nota di aggiornamento al document di economia e finanza*"). As the relevant data are available with a two-year lag, estimates for 2019 will be published in autumn 2021.

factor productivity (-0.5%). Labour productivity in 2019 shrunk by 0.4%, as parts of the services sector (professional services, private education and health services) and the industrial sector registered a decline in productivity, the latter reversing for the first time the positive trend that began in 2010. In 2020, the steep fall in hours worked implied a sizeable increase in labour productivity per hour worked, as the drop in hours worked exceeded the fall in economic output. Real labour productivity increased by an exceptionally strong 2.3% compared to 0.2% for the EU on average.

The COVID-19 pandemic and the associated policy response is set to influence both short- and long-term productivity developments. The pandemic shock and the necessity to reorganise in-company and intercompany working arrangements at short notice is likely to unlock some productivity reserves, despite the belowEU-average use of ICT. For example, the share of telework in Italy increased from 2% to 33% in 2020 and e-commerce activities rose significantly over the last year, with retail trade (values) through e-commerce 38.4% higher in January 2021 than one year before. However, long-term productivity dynamics remain subdued, particularly in services and in some southern regions. A more efficient capital allocation, inter alia intermediated through non-bank financial institutions, would support this necessary transition. In addition, several policy measures likely to be included in the NRRP have the potential to spur productivity, notably through substantial investment in innovation and digitalisation. Investment in infrastructure could particularly improve the competitiveness of the South. Major challenges concern the smooth unwinding of emergency support measures that could undermine an efficient capital allocation by keeping non-viable companies afloat and postpone the necessary reallocation of physical and human capital.

Activity and employment rates, in particular of women and young people, remain markedly below the EU average. Policies to raise labour market participation, in particular the reform of active labour market policies as part of both the 2015 "Jobs Act" and the recently introduced minimum income scheme have been adopted but are still not yet fully implemented. The government took some steps to strengthen public employment services (PES), including through staff reinforcements, albeit mostly on short-term contracts (recently prolonged until end-2021 following the adoption of the Decreto Sostegni) and without clear job descriptions. Thus, PES' job placement capacity remains low. Moreover, more measures to increase women's participation in the labour market are needed, in particular a better and more accessible supply of care facilities, not only but especially in the south, and a tax reform that tackles the "welfare trap" and the high tax wedge for second earners.

Banks continued to reduce their stock of legacy NPLs but further structural reforms are needed to avoid an accumulation of new NPLs and enable banks to provide credit to the economy. They have taken advantage of a dynamic secondary market for impaired assets, the provisions in the Cura Italia Decree, that allow banks to convert deferred tax assets into tax credits against NPL sales, and the state supported NPL securitisation scheme ("*Garanzia sulla Cartolarizzazione delle Sofferenze*" – GACS). Moreover, banks have benefitted from government measures to support credit and the guidance of the supervisory authorities on the use of the flexibility allowed under the rules for classifying loans, which aim to reduce the potentially pro-cyclical effects of an increase in credit risk. Nevertheless, the continuation of structural reforms is a key prerequisite for avoiding a further accumulation of new NPLs and maintaining the capacity of banks to provide credit to the economy. In this respect, the full implementation of the 2019 insolvency code, postponed from August 2020 to September 2021, coupled with improvements in the digitalisation and efficiency of the court system would be beneficial in order to cope with a potential increase in bankruptcies.

Overall assessment

Italy's imbalances are not expected to improve in the near term, while it is not yet possible to assess the full impact of the COVID-19 crisis. The increase in the government debt ratio over 2020 and 2021 is due to the COVID-19 emergency and the policy support needed for households and firms. A fast decline of the government debt ratio in the coming years will require effective policies and reforms to support potential growth as well as an efficient use of available national and European resources. The announced reform of personal income taxes will be an important opportunity to tackle longstanding weaknesses of Italy's tax system. The important measures taken against tax evasion are starting to bear fruit but it will be key to avoid a weakening of the reform momentum. Pension expenditure is projected to grow at a significant pace in the coming years under a no-policy-change assumption, reducing resources for growth-enhancing expenditure. Productivity growth rose sizeably in 2020, but the long-term trend remains subdued. Public investment is on an increasing trend since 2019, albeit from a low level, but a higher administrative capacity is required to reap the full benefits of higher public capital spending. The unemployment rate continued to fall, partly due to a drop in the labour force, but joblessness continues to persist, especially among the young. Measures to increase labour market participation, in particular of women, tend to go in the right direction. However, they are not yet sufficient, while other challenges, notably the tax wedge, are not yet effectively addressed. The situation of banks has considerably improved, with a further reduction of NPLs. Still, the stock of NPLs remains high, especially for small and medium banks, while firms' limited recourse to non-bank finance leaves them vulnerable to banking shocks. Significant investment, particularly in research, innovation and infrastructure, accompanied by reforms aiming to remove persistent barriers to investment planning, execution and absorption, including in the public administration (e.g. efficiency and timeliness of the public procurement system, see Recital 27 to 2020 CSRs) and the business environment (e.g. regulatory barriers to competition in sectors such as business services and retail, see CSR 2019.3 and Recital 26 to 2019 CSRs) are needed to boost Italy's productivity dynamics, employment and growth, supporting in turn the reduction of the public debt-to-GDP ratio.

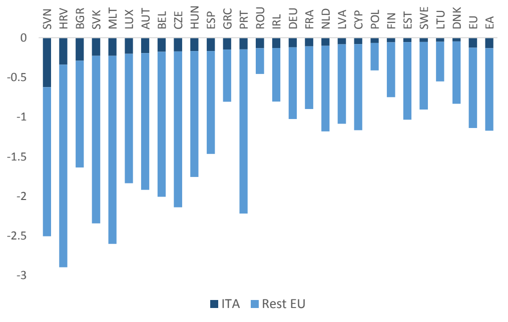
Box 1.1: **Spillovers Italy**

The pandemic recessions in EU Member States also reflected faltering cross-border demand from trade partners. The drop in Italian aggregate demand due to the pandemic and the containment measures played a significant role in the output declines of its closest partners. In the recovery, cross-border spillovers may undo their negative impact of 2020, yet the uncertain timing and extent of the recovery make a forward-looking assessment difficult. As a first step, this box thus aims to take stock of the heterogeneous spillovers of Italian demand to other Member States' value added in 2020. It quantifies cross-border effects applying latest production data to input-output estimates. ([1]) This allows for synthesizing supply chain effects, e.g. detailing how Italian consumption from domestic providers affected those providers' foreign suppliers, and their suppliers in turn. While these results allow for country-specific sectorial detail, note that they reflect partial equilibrium effects in the goods and services market only – they do not include any second-round effects on foreign wage income, interest rates, prices etc., which may be stronger.

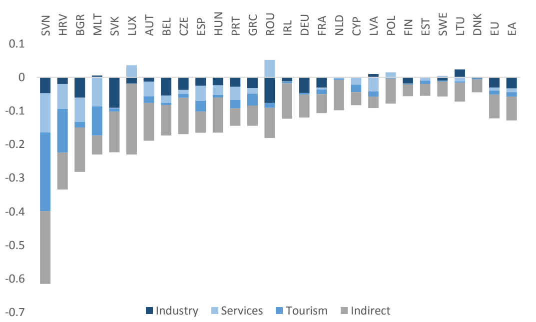
Graph 1a shows the overall cross-border impact of the heterogeneous final demand changes during 2020, and highlights the Italian contribution therein. Overall, 1.2 pp of the 2020 EU output decline can be attributed to cross-border demand effects, with German demand accounting for 0.1 pp thereof. Yet small open service-intensive economies were hit more strongly than the average, and non-negligible part of it can be attributed also to decline of Italian demand. The importance of Italian demand varies significantly across partners, with higher relevance in neighbouring countries. For instance, a quarter of the VA impact in Slovenia due to intra-EU demand changes is driven by a reduction in Italian demand. A notable impact has been also recorded for Croatia, Bulgaria or Malta.

Graph 2b highlights the heterogeneous effects of the pandemic by zooming in on the Italian contribution by sector (the dark-blue bar in Graph 1a). ([2]) The most significant are indirect spillovers, which capture supply chain interlinkages. ([3]) Such indirect cross-border spillovers account more than demand spillovers for industrial products and services for most trading partners. The decline in Italian tourists in turn accounted for the bulk of Italian demand spillovers to Slovenia, Croatia and Malta. Demand changes for non-tourist services were again relevant for the former three and several others but they seem to have had a positive impact on Luxembourg and Romania. Changes in the final demand for industry products had a strong impact on Slovakia in particular. Overall, 2020 Italian demand changes thus had a significant impact on the RoEU, in particular smaller neighbouring countries with the impact determined by Member States' tourism intensity and/or their degree of integration with Italian supply chains.

Graph 1a: **VA impact (%) of cross-border demand change 2019-2020**



Graph 1b: **VA impact (%) of change in IT demand 2019-2020 by category**



([1]) The estimates derive from a two-step analysis: 1) Compiling 2020 output declines at the sector-level across the globe. For the EU Member States, detailed information for 2020 is available in Eurostat. For non-EU countries, sectoral output changes in 2020 are approximated by IMF WEO GDP changes, thus implicitly abstracting from sectoral heterogeneity; 2) Using output changes in all country-sector pairs to trace back changes in final demand, based on global supply chain interlinkages as captured by the OECD ICIO tables. The resulting set of final demand changes can then be used to simulate the impact of the COVID-19 crisis on each country-sector's value added. Two important assumptions are made to allow for such a translation of output changes into demand changes. First, the technological coefficient matrix, which captures the required amount of supplies from any sector to produce a given sector's output, is assumed to have remained fixed since the latest ICIO data (2016). Second, the country allocation final demand for a specific sector is assumed to have remained proportional to 2016.

(2) Distinguishing by the source of the demand allows to quantify the impact of demand changes in a certain country on VA production in all its trading partners, by type of good or service. Given the particular nature of the COVID-19 crisis, with a strong impact on hospitality sectors, the analysis distinguishes between tourism (NACE sector I), all other services (G-N excl. I) and industry (A-F).

(3) For example, a drop in Italian demand for German cars reduces Slovak production of engines, with a knock-on effect on Czech suppliers of engine parts.

Table 1.2: **Assessment of Macroeconomic Imbalances Matrix - Italy**

	Gravity of the challenge	Evolution and prospects	Policy response
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
Productivity and competitiveness	Productivity growth has been dismal over the last two decades and the gap to the EU average has remained substantial. Weak productivity growth is largely due to low investment and innovation, barriers to competition, weaknesses in the public sector paired with a non-supportive business environment, and a lack of adequately educated people. The investment gap between Italy and the euro area since the 2008 crisis is still considerable. Productivity growth is needed to sustain competitiveness, and, together with higher employment rates, to boost GDP growth and, in turn, reduce the public debt-to-GDP ratio.	During the period 2010-19, productivity growth averaged 0.4% per year (EU: 1.2%). In 2019, growth in gross value added stagnated, as a rising labour and capital input was offset by a falling total factor productivity (-0.5%). Labour productivity in 2019 shrunk by 0.4%, as parts of the services sector and the industrial sector registered a decline in productivity. In 2020, labour productivity increased by an exceptionally strong 2.3% compared to 0.2% for the EU on average, as the drop in hours worked exceeded the fall in economic output.	Public schemes supporting innovative investment (such as Transizione 4.0) have been increased in 2020 and have a stronger focus on the digital and green transition, while the number of eligible firms is also expected to increase. Private and public investment remain low, especially in intangibles and education, although a substantial boost in some areas is expected to come from the NRRP. Some of the reforms adopted in the last years in order to address the bottlenecks holding back productivity growth, such as in competition, have not been fully implemented. Additional reforms addressing civil and criminal justice, as well as the fight against corruption, are still pending in the Parliament. In 2020, in line with past efforts, a Simplification decree was adopted to reduce red tape and speed up administrative procedures, particularly for national interest investment project. The decree also contains measures to encourage digitisation. Adequate reforms and investments are needed to strengthen administrative capacity, human capital and innovation. Reducing the infrastructure gap, including in transport would help improving the competitiveness of the South.
Public debt	In 2020 Italy's public debt-to-GDP ratio increased to 155.8%, the second highest in the euro area. Italy's high public debt is a major source of vulnerability for the economy. The high debt servicing costs crowd out productive public expenditure, reduce the fiscal space to respond to economic shocks and may give rise to a harmful snowball effect if interest rates significantly exceed nominal GDP growth. The high rollover needs entail significant refinancing risks and expose Italy's public finances to any sudden increase in financial market risk aversion. Prolonged increases in sovereign yields may have adverse economic effects through the exposure of domestic financial institutions to public debt, with possible negative spillovers to the banking sector and to financing conditions for firms and households. Given its size, Italy's public debt ratio is a potential source of negative spillovers to the whole euro area.	The debt-to-GDP ratio remained broadly stable in recent years and stood at 134.6% in 2019 before it increased by 21 percentage points in 2020 owing to the COVID-19 pandemic. It is projected to further increase to 159.8% in 2021 before declining to 156.6% in 2022 based on the Commission 2021 spring forecast. The primary balance deteriorated from a surplus of 1.8% of GDP in 2019 to a deficit of -6% of GDP in 2020, and is expected to further deteriorate to -8.4% of GDP in 2021, before improving to -2.8% of GDP in 2022. Sovereign yields declined markedly in 2020 also thanks to the ECB policy support. In 2020, foreign investors decreased their holdings of Italy's sovereign bonds, while the ECB increased its share; the share held by Italian banks remained broadly stable. Fiscal sustainability risks are high in the short and the medium term, on the basis of the standard fiscal sustainability gap indicators and the Commission's debt sustainability analysis. While the low interest rate environment substantially mitigates financial sustainability risks in the short term, sustained real GDP growth and prudent fiscal policies will be crucial to substantially reduce the debt ratio in the coming years.	Policy support to the economy amounted to around 6.5% of GDP in 2020 and included a broad range of measures aimed at supporting households and firms. Additional support amounting to around 4.1% of GDP in 2021 was legislated in March and May 2021 in light of the developments of the pandemic. Government contingent liabilities are expected to have increased substantially in 2020 due to public guarantees issued in response to the crisis. The use of additional funds for firms capitalisation amounting to around 3% of GDP will likely increase government gross debt in the coming years The important measures taken against tax evasion in recent years are starting to bear fruits. The temporary early retirement scheme legislated in 2019 is expected to end in 2021 as originally planned. It will imply higher pension expenditure until 2028, increasing the longstanding bias of public spending towards old-age pensions.

(Continued on the next page)

Table (continued)

Adjustment issues

Labour market participation and unemployment	The participation rate declined and remained relatively low, particularly for women. The risk of labour market exclusion is particularly high for women and the young: the youth unemployment rate and the share of young people not in employment, education or training (NEET) are among the highest in the EU. The unemployment rate fell following the COVID-19 shock, with employees with fixed-term contracts and the self-employed particularly affected. The low labour market participation has also a bearing on potential economic growth.	The unemployment rate temporarily fell in 2020, thanks to policy measures such as short-time working schemes but also due to a drop in activity rates. The unemployment rate averaged 9.2% in 2020 down from 10% in 2019, but has climbed to 10.2 % in February 2021. It is not expected to decline in 2021, partially due to the impact of containment measures. Long-term and youth unemployment increased in the wake of the pandemic shock and the participation rate has not recovered the pre-crisis level.	The reform of active labour market policies and the strengthening of work-based learning and skill formation could help labour market transition and smooth the necessary adjustment of the labour market following the pandemic shock. However, implementation is proving challenging. Measures to foster labour market participation have been limited.
Banks' asset quality	The gross non-performing loan (NPL) ratio has declined from 7.4% in September 2019 to 5.6% in September 2020. Despite the outbreak of the pandemic and the subsequent reduced economic activity, the NPLs ratio has remained low until now, but still above the euro area average of 2.7%. The CET1 ratio further increased to 15.5% in December 2020, albeit benefitting from the capital relief measures (i.e. mainly the Capital Requirement Regulation-CRR "quick fix" as a response to the pandemic). On the back of the increase in loan-loss provisions and pressures on net interest income, profitability remains subdued with the return on equity standing at 1.9% in December 2020.	The decline in economic activity, triggered by the COVID-19 crisis, is likely to put strain on borrowers' ability to repay loans going forward. This may negatively affect the asset quality and the already subdued profitability of the Italian banking sector, notably when support measures, such as guaranteed loans and debt moratoria will be phased out.	The disposal of NPLs has been supported by the dynamic secondary market for impaired assets, by the provisions in the Cura Italia Decree, which allow banks to convert deferred tax assets into tax credits against NPL sales and by the NPL securitisation scheme (GACS). Moreover, banks have also benefitted from government measures to support the provision of liquidity to companies and the prudential guidance of the supervisory authorities on the flexibility allowed for the classification of loans, which aim to reduce the potentially pro-cyclical effects of an increase in credit risk.

Main takeaways

- The public debt-to-GDP ratio, which was already very high in 2019, has increased sharply due to the COVID-19 pandemic, driven by the drop in GDP and the cost of the emergency policy response. Productivity growth has been persistently low and that hampers potential GDP growth, which in turn limits the room for debt deleveraging. Persistently high long-term unemployment holds back future growth. Banks' balance sheet repair has considerably progressed and liquidity support measures significantly increased bank-lending volumes within the corporate sector but asset quality issues have persisted and the sovereign-bank nexus remains sizeable.
- Imbalances are not expected to unwind soon or could even deteriorate in the near term. The government debt-to-GDP ratio is expected to further increase to 159.8% in 2021, before declining to 156.6% in 2022, based on the Commission 2021 spring forecast. Not accounting for planned reforms, productivity growth is set to remain subdued and not closing the gap with the EU. The NPLs ratio has further declined but may increase going forward especially when some temporary support measures are phased out.
- A sustained reform agenda is crucial to facilitate the unwinding of Italy's macroeconomic imbalances. While decisive actions have been taken to support the economy amid the COVID-19 shock, the progress with policies concerned with structural issues has been uneven. For instance, the implementation of reforms was particularly slow or limited in the areas of active labour market policies, in strengthening administrative capacity and competition. Despite important progress in fighting tax evasion, some longstanding weaknesses of the tax system persist. Though banks further progressed in repairing their balance sheets, the risks of an increase in NPLs and a deterioration of the profitability needs to be considered once support measures will be phased out in the medium term. A substantial boost in some areas, both in terms of investment and reforms, is expected to come from the NRRP.

Source: European Commission Services

Table 1.3: **Selected economic and financial indicators, Italy**

	2004-07	2008-12	2013-18	2019	2020	2021 (forecast)	2022 (forecast)
Real GDP (y-o-y)	1.4	-1.4	0.1	0.3	-8.9	4.2	4.4
Potential growth (y-o-y)	0.8	-0.2	0.0	0.6	-0.6	0.7	0.4
Private consumption (y-o-y)	1.2	-1.1	0.5	0.3	-10.7	3.1	4.9
Public consumption (y-o-y)	0.3	-0.4	-0.3	-0.8	1.6	2.9	0.1
Gross fixed capital formation (y-o-y)	1.8	-4.9	0.5	1.1	-9.1	9.9	8.4
Exports of goods and services (y-o-y)	5.9	-0.9	2.8	1.6	-13.8	10.4	7.9
Imports of goods and services (y-o-y)	5.3	-2.9	3.4	-0.7	-12.6	11.5	8.7
Contribution to GDP growth:							
Domestic demand (y-o-y)	1.2	-1.7	-0.1	0.2	-7.8	4.2	4.4
Inventories (y-o-y)	0.1	-0.2	0.2	-0.6	-0.3	0.0	0.0
Net exports (y-o-y)	0.1	0.6	0.1	0.7	-0.8	0.1	0.0
Contribution to potential GDP growth:							
Total Labour (hours) (y-o-y)	0.3	-0.4	0.1	0.4	-0.5	0.5	0.1
Capital accumulation (y-o-y)	0.6	0.3	0.0	0.0	-0.2	0.0	0.1
Total factor productivity (y-o-y)	-0.1	-0.1	-0.1	0.1	0.1	0.2	0.2
Output gap	2.1	-1.2	-2.3	0.6	-8.6	-4.8	-1.4
Unemployment rate	7.2	8.4	11.7	10.0	9.2	10.2	9.9
GDP deflator (y-o-y)	2.3	1.5	1.0	0.8	1.2	0.8	1.2
Harmonised index of consumer prices (HICP, y-o-y)	2.2	2.4	0.7	0.6	-0.1	1.3	1.1
Nominal compensation per employee (y-o-y)	2.9	2.0	0.6	1.6	2.6	0.5	1.9
Labour productivity (real, person employed, y-o-y)	0.3	-1.0	0.0	-0.2	-7.0	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2.3	2.4	0.6	1.4	1.0	1.7	-0.2
Real unit labour costs (y-o-y)	0.0	0.8	-0.4	0.6	-0.2	0.8	-1.4
Real effective exchange rate (ULC, y-o-y)	1.4	-0.1	-0.1	-2.3	.	.	.
Real effective exchange rate (HICP, y-o-y)	0.1	-0.8	0.2	-2.2	1.0	0.7	-0.8
Net savings rate of households (net saving as percentage of net disposable income)	8.6	4.6	3.0	2.5	10.3	.	.
Private credit flow, consolidated (% of GDP)	9.9	2.9	0.1	0.2	.	.	.
Private sector debt, consolidated (% of GDP)	99.7	121.3	114.9	106.6	.	.	.
of which household debt, consolidated (% of GDP)	34.1	42.4	41.8	41.2	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	65.5	78.9	73.1	65.4	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	4.4	8.3	10.7	5.4	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.2	0.6	2.9	3.4	5.7	11.3	7.6
Corporations, gross operating surplus (% of GDP)	23.0	21.3	21.2	21.3	21.3	22.0	22.7
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	0.9	1.7	1.3	7.3	3.3	1.3
Deflated house price index (y-o-y)	3.7	-1.6	-4.3	-0.6	2.2	.	.
Residential investment (% of GDP)	5.5	5.4	4.3	4.1	4.1	.	.
Current account balance (% of GDP), balance of payments	-1.1	-2.2	2.0	3.2	3.6	2.9	3.2
Trade balance (% of GDP), balance of payments	-0.2	-0.7	2.7	3.3	3.8	.	.
Terms of trade of goods and services (y-o-y)	-1.4	-1.0	0.4	0.7	3.7	-1.3	-0.1
Capital account balance (% of GDP)	0.1	0.1	0.0	-0.1	0.0	.	.
Net international investment position (% of GDP)	-17.9	-21.0	-14.2	-0.9	1.8	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (1)	-9.4	-22.4	-14.3	0.4	1.2	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	94.5	113.9	121.2	122.8	139.6	.	.
Export performance vs. advanced countries (% change over 5 years)	0.5	-12.5	-7.9	-3.8	2.4	.	.
Export market share, goods and services (y-o-y)	-2.6	-5.8	-0.1	-1.4	-2.3	2.3	2.4
Net FDI flows (% of GDP)	0.8	1.0	0.0	0.1	0.6	.	.
General government balance (% of GDP)	-3.1	-3.7	-2.6	-1.6	-9.5	-11.7	-5.8
Structural budget balance (% of GDP)	-4.7	-3.4	-1.5	-2.0	-4.9	-9.3	-5.1
General government gross debt (% of GDP)	105.6	117.6	134.1	134.6	155.8	159.8	156.6
Tax-to-GDP ratio (%) (3)	40.1	41.9	42.7	42.6	43.2	42.1	41.7
Tax rate for a single person earning the average wage (%) (4)	28.6	30.2	31.1	31.5	29.0	.	.
Tax rate for a single person earning 50% of the average wage (%) (4)	19.3	21.7	18.2	16.4	14.8	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3) The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
(4) Defined as the income tax on gross wage earnings plus the employee's social security contributions less universal cash benefits, expressed as a percentage of gross wage earnings
Source: Eurostat and ECB as of 2021-05-05, where available; European Commission for forecast figures (Spring forecast 2021)

2. THEMATIC ISSUE: PUBLIC DEBT

Debt developments

The COVID-19 pandemic caused a sharp increase of the government debt-to-GDP ratio in 2020. After having remained broadly stable in recent years, Italy's debt-to-GDP ratio increased by 21 percentage points in 2020, from 134.6% of GDP in 2019 to the historically high level of 155.8%. The main driver was the drop in GDP in real terms (12.9 pps higher debt ratio), which, together with a stable contribution from interest expenditure, caused a sizable debt-increasing snowball effect, only marginally offset by the positive GDP deflator. The primary balance, whose historical surplus had broadly balanced other debt-increasing factors in recent years, turned negative for the first time since 2009 contributing to an increase in the debt-to-GDP ratio by 6 pps. Government gross debt increased in 2020 also as a result of several liquidity operations, such as tax deferrals, reflected in a small debt-increasing stock-flow adjustment.

The government deficit increased substantially in 2020, mainly due to the cost of the policy response, and is expected to further increase in 2021 before declining in 2022. The government deficit increased from the historical low of 1.6% of GDP in 2019 to 9.5% of GDP in 2020, mostly due to the cost of the policy response. The government adopted a large number of measures to support households and firms in light of the COVID-19 emergency and related restrictions to economic activity, with an overall budgetary impact of around 6% of GDP in 2020. These measures included temporary extensions of the duration and coverage of short–time work schemes, allowances for self-employed workers, partial compensation for incurred losses to firms and additional funds for healthcare and civil protection. The government also provided a variety of subsidies to the most exposed sectors, implemented temporary income support schemes for households and expanded budgetary provisions for government guarantees. While revenues from indirect taxes declined substantially, reflecting the drop in private consumption, revenues from direct taxes decreased only marginally thanks to the policy support to employment. In 2021, the government deficit is expected to further increase to 11.7% of GDP, due to the cost of the prolonged policy support. The 2021 budget implies a deficit-increasing impact of around 1.4% of GDP. Besides additional economic support to the most exposed sectors, it included several measures aimed at supporting the economic recovery, such as the reduction of social contributions for new hires and for firms operating in poorer regions, substantial incentives for building renovations and equipment investment as well as a reform of family benefits. ([3]) In light of the pandemic developments, two additional fiscal packages were adopted in March and May 2021, worth respectively 1.8% and 2.3% of GDP. The package adopted in March provided for the extension of wage supplementation schemes and additional financial support to firms and households. The decree adopted in May further extended support to the economy, with a special focus to the corporate sector. In 2022, the government deficit is projected to decline to 5.8% of GDP, thanks to the effect of the economic recovery on government revenues and lower public spending. Overall, measures adopted in 2020 and 2021 are expected to still imply costs amounting to around 2% of GDP in 2022. These projections also take into account the cost of measures adopted before the beginning of the COVID-19 pandemic which have not been offset by equivalent financing measures.

The measures adopted to support corporate liquidity are expected to increase government contingent liabilities as well as gross debt in the coming years. Government contingent liabilities were comparatively low at the end of 2019 (5.2% of GDP) but are expected to have increased substantially in 2020 following the extension of government guarantee schemes (see section 3.2.3). The duration of government guarantees varies depending on the scheme, and will last six years for most guarantees to SMEs. The new guarantee scheme for exporting firms, which is not yet operational, is expected to become structural. Budgetary provisions of 0.7% of GDP for standardised guarantees have been included in the 2020 government deficit, reducing risks for the government balance. However, the provisions are

([3]) Some of these measures, and in particular the reduction of social contributions for firms operating in poorer regions and the incentives for equipment investment and building renovations are expected to be partly financed with NGEU resources.

not recorded into government debt, which is thus subject to higher risks. In 2020, the government also created a new fund amounting to 2.7% of GDP for the capitalisation of strategic firms (*Patrimonio destinato*), and increased by EUR 4 billion (0.2% of GDP) the existing fund for the capitalisation of SMEs (*Patrimonio PMI*). These funds are meant for government participation in strategic sectors through several financial instruments, and will increase government gross debt when the corresponding operations will take place. The new fund *Patrimonio destinato* will be in place for 12 years, although its duration can be changed via a decree of the Ministry of Finance. While some sizable operations are being discussed for 2021, the allocated resources represent a ceiling and there is no legal provision requiring their full use.

Based on the Commission 2021 spring forecast, the government debt-to-GDP ratio is expected to further increase in 2021, before declining in 2022. In 2021, the projected rebound in real GDP growth is expected to cause a debt-decreasing snowball effect for the first time since the previous financial crisis (lowering the debt ratio by 4.1 pps everything else being equal). The stock-flow adjustment is also assumed to reduce the debt ratio by 0.2 pps, thanks to the payment of taxes deferred in 2020 and the pre-financing of RRF resources, which are expected to more than offset the planned use of funds for firms' capitalisation. At the same time, in light of the cost of the prolonged policy support, the contribution of the primary balance is expected to more than offset the debt-reducing snowball effect and stock-flow adjustment, leading to an increase of the debt-to-GDP ratio by 4 pps, to 159.8%. In 2022, the debt-reducing snowball effect is set to further increase thanks to the accelerating real GDP growth, while the primary deficit is projected to decline to 2.8% of GDP. Overall, the debt-to GDP-ratio is projected to decrease by 3.2 pps, to 156.6%.

Fiscal sustainability

Based on the European Commission Debt Sustainability Analysis (2021 spring forecast), Italy is deemed to face *high* fiscal sustainability risks in the short and medium term. **([4])** At 0.47, the index for fiscal risks in the short term (S0) is just above the threshold pointing to high risks (0.46). While the financial competitiveness sub-index points to low risks (0.36), the fiscal sub-index remains high (0.40), as all its components are above the relevant threshold. In particular, government gross financing needs, which include net borrowing requirements as well as debt rollover needs, have surged in 2020 due to the COVID-19 crisis and are expected to remain sizeable from 2021 onwards, although on a declining trend. High risks in the medium term reflect the fact that, under the baseline assumptions, government debt would remain above 155% of GDP for most of the next decade, peaking at 158.8% in 2024 and declining to 153.4% by 2030. Alternative scenarios, both favourable and unfavourable, confirm these risks. At the same time, the implementation of reforms and investments under the Next Generation EU, notably the Recovery and Resilience Facility, is expected to have a substantial positive and persistent impact on GDP growth in the coming years, which, ceteris paribus, should contribute to strengthen debt sustainability.

In the long term, Italy is deemed to face medium fiscal sustainability risks. The fiscal index S2 points to low risks in the long term, mainly thanks to the limited increase in ageing costs in the baseline scenario, which reduces the fiscal adjustment needed to stabilise the debt ratio over an infinite horizon. However, a more comprehensive debt sustainability analysis taking into account also the high level of government debt points to high risks, resulting in an overall classification of medium fiscal sustainability risks in the long term.

Debt composition and holding sectors

In 2020, the share of government securities held by European institutions increased, while the share of foreign investors declined. The share of government securities held by the Bank of Italy for the ECB increased from 19.9% in January and February 2020 to 25.8% in February 2021. In absolute terms, government securities held by the central bank have increased by EUR 144.8 billion over February-December 2020, i.e. above the total increase in outstanding government securities recorded over the same period (EUR 105.4 billion). In 2020, Italy also benefitted from EUR 27.4 billion of European loans under the programme SURE, for financing the temporary extension of short-time work schemes and similar measures to address the emergency. Most resources were transferred to Italy between October 2020 and April 2021, with very favourable financial conditions and an average maturity close to 15 years.

([4]) See Article 126(3) report (June 2021) and also the Debt Sustainability Monitor 2020 for detailed methodological aspects.

Conversely, the share of government securities held by foreign investors declined from 36.5% in February 2020 to 32.4% in February 2021. Half of this decline took place in March 2020, when, based on balance of payments data, foreign investors disposed of EUR 51.5 billion of Italian government securities, above the large divestment observed in June 2018 (EUR 33 billion). The share of government securities held by domestic banks increased by around 2 percentage points in March and April 2020, before returning closer to 18% by February 2021. Conversely, the share held by the retail domestic sector remained broadly stable until February 2021 at around 7%, recording a small increase of EUR 7 billion in absolute terms compared to February 2020 also thanks to the new initiatives to attract these investors.

Italy's sovereign yields declined substantially in the course of 2020, reaching historically low levels across the yield curve. After hovering around 1% at the beginning of 2020, Italy's 10-year sovereign yields experienced some turbulences in March and April 2020, when they remained above 2% for several days. However, after the end of April 2020, they remained on a declining trend, reaching 0.9% by the beginning of May 2021. Similarly, the spread vis-à-vis 10-year German bonds declined from around 235 basis points at the end of April 2020 to around 110 basis points at the beginning of May 2021. At the beginning of May 2021, yields on the secondary market were negative for fixed term securities up to a maturity of 3 years. These developments, which are also due to support measures such as the Pandemic Emergency Purchase Programme of the ECB (see section 3.2.3), allowed interest expenditure to decline by 5% in 2020 despite the sizable net borrowing requirements.

The average maturity of Italy's outstanding government securities marginally increased in 2020, from 6.9 to 7 years. Despite the large borrowing requirements in 2020, Italy's issuance strategy took advantage of the favourable financing conditions to reduce risks, leading to a marginal decline in the share of short-term securities. The Debt Management Office also took a proactive approach to widen the investor base, including by creating two new government securities, *BTP futura* and *BTP green*, earmarked for financing the COVID-19 policy response and green expenditure respectively.

Composition of government expenditure

The positive trend of public investment was confirmed in 2020 and is expected to continue in the coming years. Government gross fixed capital formation had been on a declining trend for several years following the previous crisis, due to several factors including the implementation of new fiscal rules at the subnational level and more complex provisions for tender procedures. In 2019, this trend was reversed and government gross fixed capital formation increased by 9.8%, mainly thanks to the increased flexibility in the use of budgetary surpluses from subnational governments. In addition, since 2017 the government has increased the allocation of national resources for public investment with the creation of several medium-term funds. In 2020, despite the slow implementation of projects in the first half of the year, government gross fixed capital formation increased by 6.7% in absolute terms, reaching 2.7% of GDP from 2.1% of GDP in 2018. In the coming years, government investment is expected to continue increasing, thanks to the large national funds allocated and the European grants under the RRF. An efficient and timely use of resources will require a substantial administrative effort.

Before declining in the long term, pension expenditure is expected to grow significantly in the coming years, reducing resources for productivity enhancing expenditure. Italy's pension expenditure has been traditionally high in comparative terms. The 2012 pension reform revised access criteria and the definition of pension benefits after a transition period, ensuring the sustainability of the pension system in the long term. The immediate increase in the statutory and early retirement ages also allowed substantial savings in the short term, reducing yearly growth in pension expenditure over 2014-2018 to an average of 1.1% compared to 3.4% over 2003-2013. As an effect of demographic factors, pension expenditure was expected to accelerate its growth from 2019, increasing substantially in the medium term. The temporary early retirement scheme implemented in 2019 further increased pension expenditure over 2019-2028, by up to 0.4% of GDP per year. Overall, based on the projections underlying the 2021 Ageing Report and assuming no extension of the new temporary early retirement scheme beyond 2021, pension expenditure is expected to increase from 15.4% of GDP in 2019 to 18% of GDP in 2036, before slowly declining to 13.6% of GDP by 2070.

Yearly spending reviews have so far achieved the saving targets, but could benefit from a more strategic approach and wider scope. In 2018, the government implemented the first yearly spending review as part of the reformed budgetary process. Reports on this review concluded that, although the target savings of EUR 1 billion had been achieved, ministries tended to reach such targets by cutting or postponing spending programmes and only partially through efficiency gains. No standard review was implemented in 2019, and in 2020 the process has been suspended due to the COVID-19 pandemic. Future spending reviews could benefit from a more strategic approach aimed at better improving spending efficiency and prioritisation, as well as from the involvement of subnational governments which are responsible for around 30% of total public expenditure. In this regard, the implementation of the fiscal federalism reform, which was launched in 2009 also with the aim of encouraging spending efficiency at the subnational level, is not yet completed.

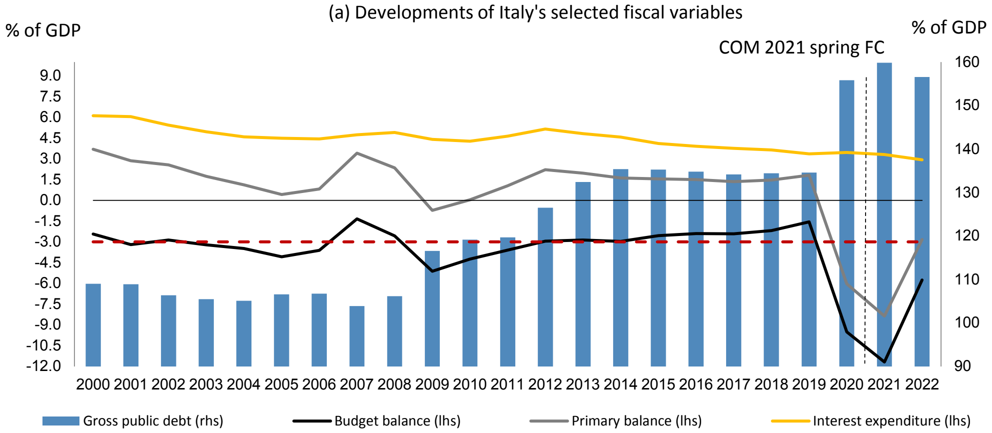
Taxation

Italy's tax system suffers from long-standing weaknesses, including a high tax burden on labour. In 2020, the tax wedge for a single earner with an average wage stood at 46.4%; this remains among the highest in the EU, especially due to the high social contributions paid by employers. The high tax wedge on labour represents an important obstacle to investment in Italy. Conversely, other sources of revenues less detrimental to growth, such as VAT and property taxes, are underused. Concerning VAT, the relatively low revenues are due to the high level of tax evasion and the extended use of reduced rates, while the tax base for property taxes is outdated and first residences are exempted also for high-income households. In addition, the practice of systematically extending concessions for public goods without new tenders, in addition to be against European provisions, generates a significant loss of revenue. There are numerous tax expenditures, which in some cases provide weak incentives to energy efficiency, discourage work by second earners or imply very high marginal tax rates. The government plans to implement a general reform of personal income taxes, for which resources amounting to 0.1% of GDP have been budgeted from 2022. However, no details are available yet.

Important measures against tax evasion have been implemented in recent years, but the tax gap is still very high. The revenue loss from tax evasion is estimated by the government at EUR 108.1 billion in 2017, mainly related to VAT (EUR 33.3 billion) and income taxes paid by self-employed and small firms (EUR 31.6 billion). Preliminary estimates indicate that evasion has declined in 2018, with a lower revenue loss from VAT by EUR 3.5 billion, also thanks to the implementation of the so-called "split payment". It is likely that tax evasion further declined in 2019, thanks to important measures such as the compulsory electronic invoicing for all private sector transactions and the revised methodology for estimating ex ante taxpayers' income (so-called "ISA-coefficients"). In 2020, the compulsory electronic transmission of bills and receipts has also been implemented. In addition, in order to discourage tax evasion from omitted billing and invoicing and given the comparatively low share of electronic payments in Italy, financial incentives for consumers who pay electronically have been implemented from December 2020 until June 2022. At the same time, the existing general obligation to accept electronic payments is not enforced due to a lack of controls and effective administrative fines. In March 2021 the government also adopted a general cancellation of past tax liabilities (*cartelle esattoriali*) up to EUR 5 000 related to the period 2000-2010, for taxpayers with yearly income below EUR 30 000. Although the measure is aimed at cancelling tax liabilities unlikely to be collected, it includes no specific provisions securing this purpose and implies a revenue loss estimated at EUR 1.6 billion in 2021 (0.1% of GDP). Overall, the measure risks worsening tax compliance by implicitly rewarding non-compliant behaviours.

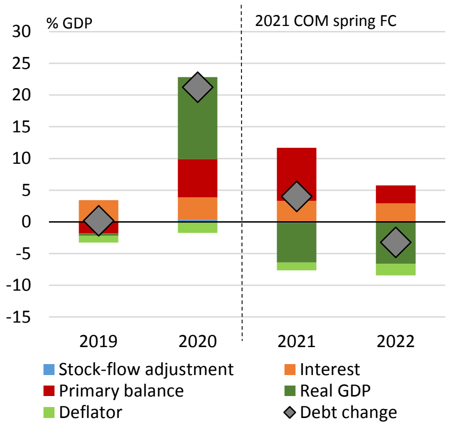
Graph 2.1: **Thematic Graphs: Public debt**

(a) Developments of Italy's selected fiscal variables



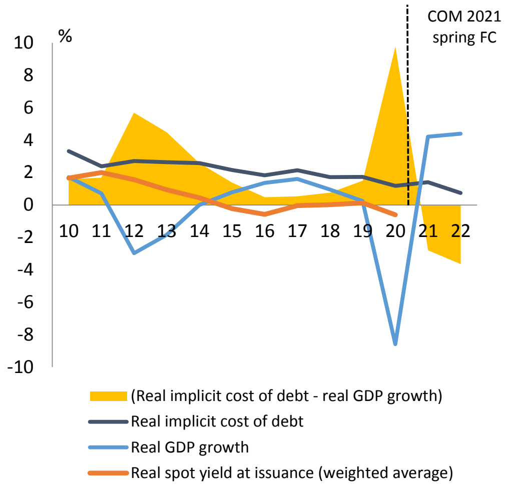
Source: Eurostat, Commission 2021 spring forecast

(b) Drivers of the government debt ratio



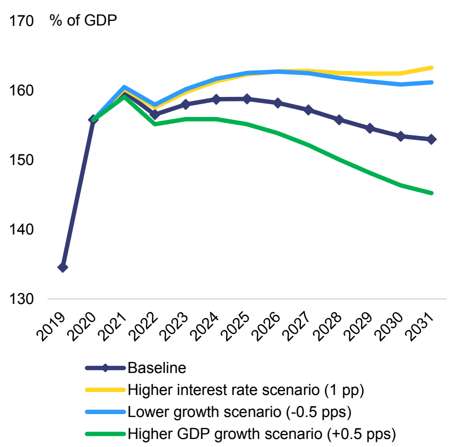
Source: Eurostat, Commission 2021 spring forecast

(c) Drivers of the "snowball" effect on public debt



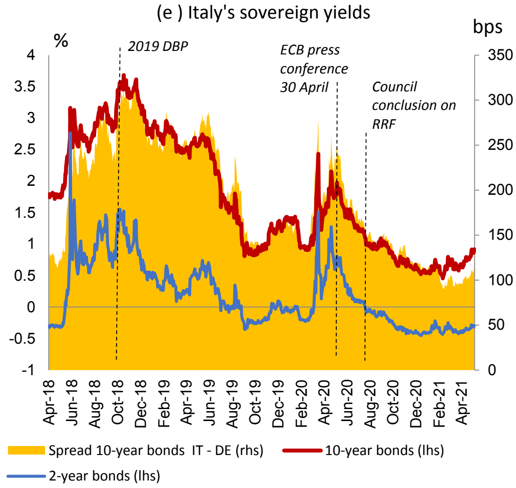
Source: Eurostat, Italy's Treasury, Commission 2021 spring forecast

(d) Public debt medium-term projections



Source: Commission Debt Sustainability Analysis (2021 spring forecast)

(e) Italy's sovereign yields



Source: Bloomberg

Source: European Commission Services

3. THEMATIC ISSUE: LABOUR MARKET

The COVID-19 pandemic laid bare the shortcomings of the Italian labour market and is set to accelerate structural change with profound effects on workers and job seekers. The risk of labour market exclusion is particularly high for women and the young: the youth unemployment rate and the share of young people not in employment, education or training (NEET) are among the highest in the EU. The activity rate, already low by EU standards, declined sharply at the onset of the COVID-19 pandemic and only partly recovered by the end of 2020. The COVID-19 pandemic is set to accelerate technological change such as automation, as firms turn to labour-replacing technologies to respond to sanitary requirements and labour shortages resulting from containment measures. Moreover, with workers and consumers moving away from offline work, retail and associated face-to-face services, the COVID-19 pandemic is likely to have a permanent effect on some sectors and occupations. Hence, the polarisation of the labour market is set to continue, where labour demand is increasingly divided into low-skilled (and low-paid) jobs and highly-qualified (and well-remunerated) jobs. While older workers will face particular challenges in adapting to ongoing structural changes, younger workers have been most impacted by COVID-19-related job losses. However, it is the low-skilled who potentially face the largest risks: they are more vulnerable to job losses related to both structural changes and the COVID-19 pandemic.

The design and pace of the policy response is likely to determine the scale of hysteresis ("scarring effects"). Amid the expected withdrawal of job support measures and the accelerated structural change of the labour market, policies need to ease and smooth labour market transitions, i.e. prepare workers for new tasks and encourage workers to move into sectors with higher productivity and better employment prospects in the long term. This would imply recalibrating existing labour market policies to protect workers and their employability instead of protecting specific jobs, for example by decoupling short-time working benefits from staff membership in a specific firm and allowing those workers who are currently covered by short-time work (STW) schemes to take up other work without immediately losing all benefits. In general, actions could tackle disincentives to work (so-called "benefits traps"), possibly through the improvement of current subsidy schemes and measures in the area of taxation (e.g. on second earners) in the context of a broader tax reform.

Temporary employees, the self-employed and job seekers bear the brunt of the labour market adjustment so far. Between February 2020 and March 2021, 895 600 jobs were lost, largely concerning employees with fixed-term contracts (-9.4% since February 2020) and the self-employed (-6.6%). ([5]) Employers adjusted their workforce by not prolonging the fixed-term contracts of temporary employees, which are in many cases women and the young, reducing the number of seasonal workers and/or by instituting a hiring freeze. By contrast, STW schemes effectively limited the job losses among employees with open-ended contracts (-1.8%). The positive trend of declining youth unemployment, albeit from a high level, reversed in 2020 and the youth unemployment rate increased to 33% in March 2021 (up from an average of 29.2% in 2019).

A strong and swift policy response helped contain the negative immediate impact of the COVID-19 shock on the labour market. The unemployment rate stood at 10.1% in March 2021, i.e. recorded unemployment was only marginally higher than before the COVID-19 crisis. This favourable outcome is owed largely to the extensive use of STW schemes, whose beneficiaries continue to be statistically counted as employed, and other support measures. According to the National Social Security Institute (INPS – *Istituto Nazionale Previdenza Sociale*), the various forms of STW schemes supported about 7 million workers in 2020. Italy also made a request for temporary financial support under the SURE instrument and was allocated a loan amounting to a maximum of EUR 27.4 billion, of which EUR 21 billion have been disbursed by February 2021. However, the activity rate – already relatively low

([5]) In January 2021 the Italian statistical office (Istat) implemented Regulation (EU) 2019/1700 and Commission Implementing Regulation (EU) 2019/2240. As a consequence, employees who are covered by STW schemes for more than three months (and are formally still employed) are counted as non-employed in the Labour Force surveys (LFS). The same rule applies to self-employed who do not work for more than three months, even though their business might formally still exist.

by EU standards – dropped from 65.4% in Q4 2019 to 63.9% in Q4 2020 and the labour force shrunk by 2.6%, as in particular women exited the labour market (-4.0% vs. -1.5% for men).

Policies such as the general dismissal ban ("blocco dei licenziamenti") tend to influence the composition but not the scale of the labour market adjustment. Italy is the only Member State that introduced a universal ban on layoffs at the beginning of the COVID-19 crisis. This measure has been prolonged until June 2021 for workers supported by STW schemes and until October 2021 for other categories of workers. In practice, this measure mostly benefits "insiders", i.e. jobholders with open-ended contracts, to the detriment of temporary employees and seasonal workers. Moreover, a comparison with labour market developments in other Member States that did not introduce such a measure suggests that the dismissal ban was not particularly effective and proved redundant in view of the extended use of job retention schemes. The average total employment elasticity in the EU, which measures the responsiveness of employment to changes in economic activity, was 0.25 in 2020, compared with an elasticity of 0.24 for Italy. For some peer countries with a similar level of STW schemes, notably Germany and France, the employment elasticity is even lower, i.e. those countries managed to contain the labour market impact without resorting to restrictive measures such as an outright ban on layoffs. The dismissal ban might even prove counterproductive, the longer it is in place, as it hampers the necessary adjustment of the workforce at the firm level.

The temporary reduction in employers' social contributions in southern regions is likely to lower labour costs and improve cost-competitiveness in the short term but comes with significant costs. With the "August Decree", the Italian government introduced a 30% cut in social contributions, initially valid until end-2020, for firms in regions with a per-capita income in 2018 of less than 75% of the EU27 average (or alternatively with a per-capita income between 75% and 90% and an employment rate below the national average). The measure applies to all private employers, with the exception of the agricultural sector and domestic work. In practice, this SSC cut applies mostly to firms in southern Italy. As laid out in the 2021 Budget Law, the government intends to extend this measure until 2023 with an estimated fiscal cost of some EUR 5.6 billion in 2021 and EUR 4 billion in 2022 and 2023. ([6]) The measure adopted by the government is not restricted to particular segments of the labour market (e.g. young people, long-term unemployed), and applies to both existing new employment relationships, which implies an efficiency loss compared to potentially more targeted measures.

Effective active labour market policies (ALMP) and a reinforced job placement capacity of Public Employment Services (PES) are key to avoid hysteresis effects and a widening of the regional divide. The PES will not only be facing a significant rise in the number of jobseekers but also the need to reallocate many of them across occupations, sectors and regions. This requires providing them with good labour market information and support for skills development. Italy is among those Member States that spend the least on labour market services including PES (0.02% of GDP in 2018 compared with 0.43% of GDP in Germany and 0.24% of GDP in France) and invests significantly less than peer countries in re-training activities (0.11% of GDP in 2018 compared with 0.18% of GDP in Germany and 0.25% of GDP in France), while employment incentives account for a large share of ALMPs. In addition, the system is hampered by a high degree of fragmentation, associated with weak governance and widely diverging performance standards across regions.

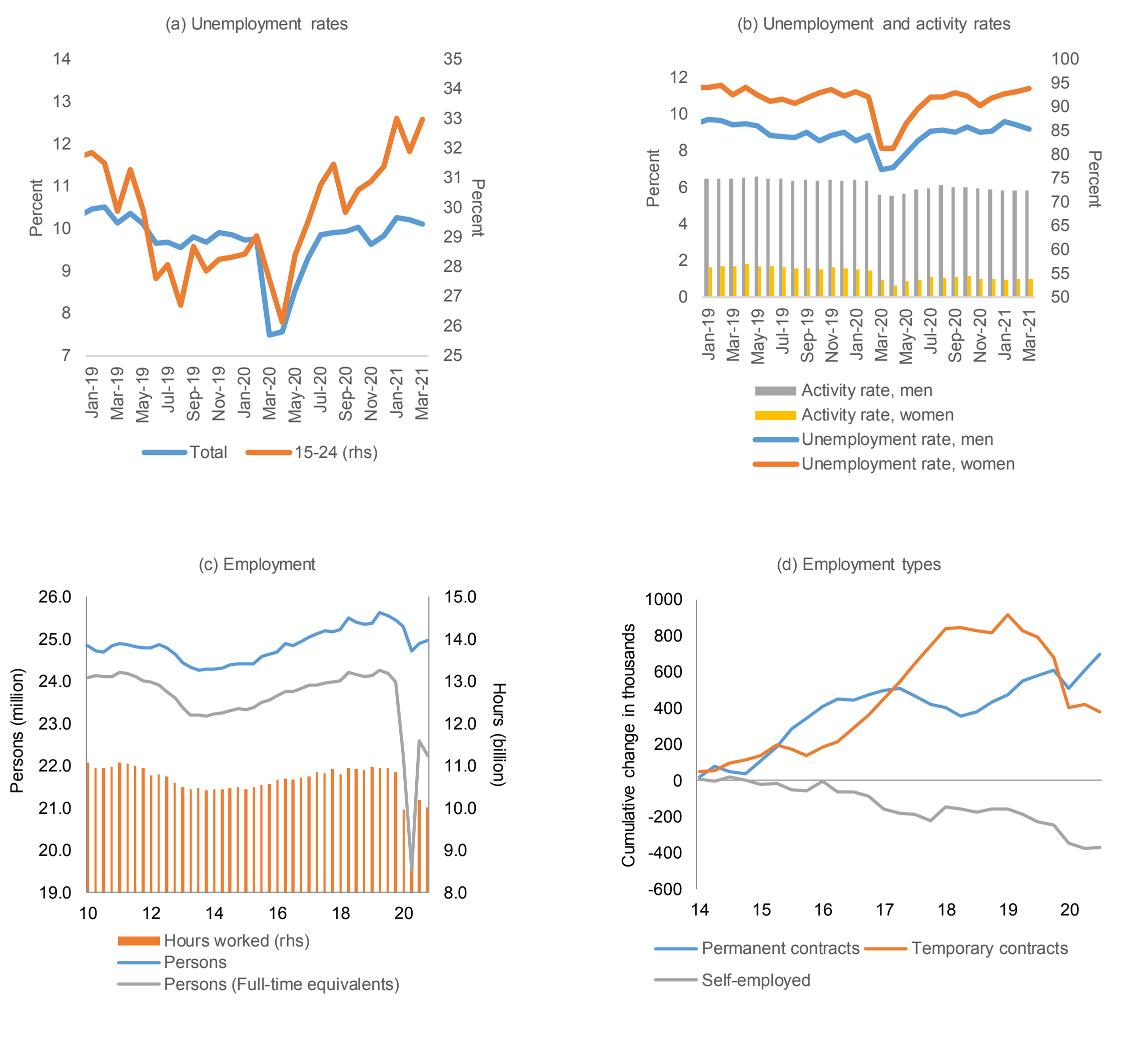
Recent labour market measures and reforms to the ALMP framework have the potential to accelerate labour market transitions and support employment. With the 2021 Budget Law, beneficiaries of unemployment benefits (*Naspi, DisColl*) and workers covered by STW schemes have become eligible for the so-called "*assegno di ricollocazione*", alongside beneficiaries of the minimum income ("*Reddito di cittadinanza*") who were already eligible since 2019. The "*assegno*" is a non-pecuniary voucher that beneficiaries can use for job search or requalification services. Moreover, the new National *Programme for the Guaranteed Employability of Workers* ("*Garanzia di occupabilità dei lavoratori – GOL*") attempts to overcome the fragmentation of local employment services. The main tasks of the programme include providing specific services (assessment, skills assessments, definition of

([6]) The measure follows two other measures already in force under Italian law. The first is the 50% exemption from social contributions for permanent employees of under 35, introduced by Law n.205/2017, for a maximum of 36 months and with a ceiling of EUR 3 000 per year. The other is the so-called 'Bonus Sud', i.e. the total exemption from social contributions introduced by the 2019 Budget Law (n.145/2018) for the recruitment of persons unemployed over 6 months, up to a maximum of EUR 8 060 per year. In contrast to the cut in non-labour costs for the under 35, the 'Bonus Sud' was only valid for 2020.

training needs, etc.) and personalised vocational training for employability. However, it is not yet clear how the new programme will interact with the existing schemes (*Reddito di cittadinanza, Naspi, DisColl*) and how governance problems between the central and the regional level will be solved.

The fight against undeclared work and labour exploitation made little progress, despite the measures implemented by the Italian authorities in recent years. In 2020, 66% of inspections by the labour inspectorate resulted in detected irregularities, a figure similar to previous years. Out of these irregularities 31% were related to undeclared work and labour exploitation. Numbers are particularly high in the agricultural sector where undeclared work and labour exploitation account for 62% of irregularities detected in 2020. The reform launched in 2020 with the goal to regularise undeclared workers has so far yielded limited results. Applications for regularisation were rather limited in number (207,542). As of March 2021, only 5% of the submitted applications were examined and only 1% resulted in the issuance of a regularisation certificate.

Graph 3.1: **Thematic graphs: Labour market**



Source: Istat.

4. THEMATIC ISSUE: FINANCIAL SECTOR

Asset Quality

Italian banks further reduced their stock of non-performing loans (NPL) over the last years, as NPL disposal has been broadly maintained during the pandemic amid government support measures. The gross NPL ratio at system level decreased from 16.8% in Q3-2015 to 5.6% in Q3-2020. However, the NPL ratio is still above the EA average of 2.7% and some of the second-tier banks have NPL ratios above the system level, though they represent a smaller part of the overall NPL stock. The share of NPLs is significantly higher for non-financial-companies (NFCs) than for households (Graph 4.1(a)). So far, most of the decrease in the legacy NPL stock has been triggered by the disposal of bad loans (*sofferenze*). As a result, unlikely-to-pay (UtP) ([7]) loans represent an increasing share of the remaining stock of NPLs, reaching 45% as of end-June 2020. As of Q3-2020, the coverage ratio at system level reached 52.3%, above the euro-area average of 46.9%. Despite the outbreak of the pandemic and the subsequent reduced economic activity, the inflow of new NPLs has remained low until now, measured by historical standards, which is also due to granted loan moratoria. The disposal of NPLs has been supported mainly by NPL securitisations benefitting from state support (GACS scheme), but also by the provisions of the “Cura Italia” Decree of March 2020, which allow banks to convert deferred tax assets into tax credits against NPL sales. Moreover, banks also benefitted from government measures to support the provision of liquidity to non-financial firms. The prudential guidance of supervisory authorities on the flexibility concerning the classification of loans, which aims to reduce the potentially pro-cyclical effects of an increase in credit risk, and the regulatory relief provided through the Capital Requirement Regulation II (CRR II) amendments also helped.

The Italian government prolonged the loan moratoria (for the second time) in December 2020 until June 2021. The Bank of Italy reported that, based on data as of 9 April 2021, 44% of moratoria have expired. The total volume of loans with non-expired moratoria (i.e. legislative and voluntary moratoria granted by banks) amounts to EUR 158 billion. The percentage of loan moratoria still in place is higher for the legislative moratoria (77% still non-expired; EUR 126 billion) than for the voluntary moratoria granted by the banking sector (27% still non-expired; EUR 32 billion). As of 9 April 2021, the non-expired moratoria granted to non-financial corporations amount to EUR 123 billion, while the moratoria to households still in place amount to EUR 29 billion. Roughly 58% of the total moratoria are also backed by state guarantees granted by the Italian government’s “Cura Italia” Decree. More efforts may be required in 2021, as banks will have to manage effectively the pressure on the quality of their loan book caused by the expiry of the moratoria measures and the gradual lifting of the public support measures to companies.

Looking ahead, the pandemic is likely to put strains on borrowers’ ability to repay loans, negatively affecting the asset quality and the already subdued profitability of the Italian banking sector. The future level of NPLs will depend on the efficiency of measures for containing the pandemic, the magnitude of the economic downturn/recovery (during and post COVID-19) and the efficiency of measures to support firms in Europe and Italy. Moreover, the performance of the stage 2 loans (according to IFRS 9 ([8]), which increased above the euro area average, also requires close monitoring in order to detect signs of further asset quality deterioration. In addition to that, the eventual phasing out of support measures, such as loan moratoria and state guaranteed loans, bears the risk of so-called cliff effects. The profitability of Italian banks, measured by the return on equity (ROE), decreased over the last years to around 4% in 2019 (Graph 4.1(b)), which was slightly below the EU average. Based on data from the Bank of Italy, the ROE dropped significantly to 1.9% at the end of 2020, mainly due to an increase in loan-loss provisions on the back of the pandemic.

([7]) In contrast with triggers relating to past-due payments, the triggers relating to unlikeliness to pay (UTP) rely less on quantitative criteria but define some events that trigger the non-performing classification.

([8]) The accounting principle IFRS9 applies a three-stage model (1 indicating best) for loan impairments based on changes in credit quality since initial recognition.

In the current volatile economic environment, further monitoring of the vulnerability linked to weaker banks is warranted. Among individual institutions, Banca Monte dei Paschi di Siena continued the implementation of commitments under the 2017 restructuring plan. The increase in loan-loss provisions due to the pandemic and legal risks coupled with the decline in net interest income has put strain on the bank's profitability, which was in negative territory in 2020. The bank announced recently that in case a structural solution with a third party buyer is not found, a capital strengthening of EUR 2.5 billion would be envisaged at market conditions and with the pro-rata participation of the Italian state. Regarding Banca Popolare di Bari, Italy's depositor protection fund (FITD) has contributed significantly to the strengthening of the capital position of this bank. As a result, the bank exited the special administration procedure in mid-October 2020 and approved its transformation into joint-stock company. Cassa Centrale Banca recently decided not to exercise a call option for acquiring over 80% of Banca Carige, which is currently predominately owned by Italy's depositor protection fund. This option could have been exercised by the end of 2020, by end of June 2021 or by end December 2021.

Provision of Credit / Access to Finance

The volume of bank loans has increased markedly since the onset of the pandemic, driven mainly by public guarantees to meet firms' greater liquidity needs, while non-bank financing has continued to remain rather subdued. Following the outbreak of the COVID-19 pandemic, the Italian authorities provided liquidity support to households and companies, which led to an increase in the demand for credit, notably by non-financial firms (see Graph 4.1(c)). Among the guarantee schemes granted by the government, the largest share of state guaranteed loans stems from the Central Guarantee Fund for SMEs, amounting to about €144 billion as of April 2021. Moreover, the guaranteed loans to corporates and SMEs granted by SACE, the Italian export credit agency, reached almost €23 billion. Lastly, a 33% guarantee for loans of micro-firms and SMEs that benefited from a payment moratorium has also been provided. As of February 2021, bank lending to the non-financial private sector grew by 5.1% YoY and even by 3.4% with respect to November 2020. This expansion in lending activity was predominately driven by firms' credit demand and to a lesser extent by households (see Graph 4.1(d)). In contrast to bank credit, non-bank financing has remained rather subdued. Decree Law 34/2020 (the 'Relaunch Decree') of May 2020 introduced a new category of PIRs (long-term individual savings plans), referred to as 'alternative PIRs', to encourage the growth of funds that invest mainly in financial instruments issued by Italian SMEs. The regulations for the first investment funds that comply with the rules for alternative PIRs have been approved, but none of those are in operation yet. Overall, lending volumes over the last year have been largely driven by the liquidity support measures that were implemented in response to the pandemic and may decrease once the measures will be phased out.

Sovereign-Bank Nexus

The sovereign-bank nexus in Italy has recently increased but significant mitigating effects have to be considered in the short to medium term. Italy's home bias regarding the sovereign holdings by banks has increased on the back of the current pandemic (Graph 4.1(e)). As such, the domestic sovereign bonds in bank portfolios as a share of total investments increased from 9.5% in February 2020 to 10.4% in February 2021, significantly above the Euro area average of 3.3%. The rise of the home bias therefore increases the vulnerability of the banking sector with respect to sovereign risk in Italy. Nevertheless, the measures included in the Capital Requirement Regulation (CRR "quick fix") and the measures taken by banks have mitigated the impact of potential increases in sovereign yields on bank balance sheets. The prudential filter for sovereign bonds implemented under the CRR "quick" fix has decreased the impact of sovereign bond price volatility on banks' core equity, albeit tapering until 2023. Moreover, Italian banks continued to rebalance their sovereign exposures in favour of the amortised cost portfolio, thereby increasingly shielding their capital base from sovereign bond volatility. Last, but not least, further significant mitigating effects have to be considered in the short term. Currently, yields for Italian sovereign bonds are standing close to historically low levels also due to support measures, such as the Pandemic Emergency Purchase Programme of the ECB that eased tensions on bond markets. As a result, short-term risks stemming from this home bias are lower than during previous periods of market turmoil. Nevertheless, further monitoring will be warranted, particularly once support and regulatory easing measures will be phased out.

Liquidity and Capital

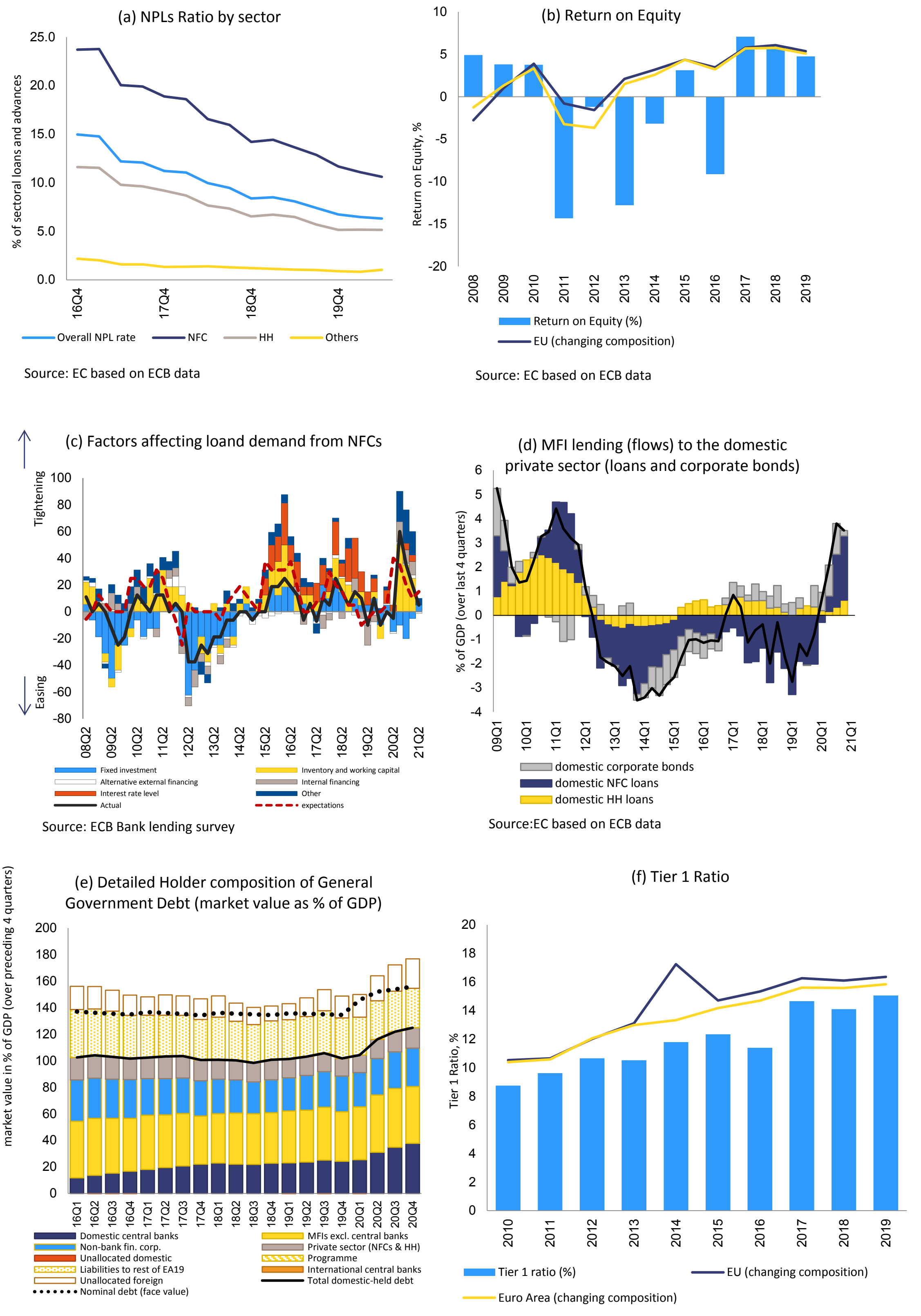
Liquidity conditions of Italian banks remain broadly stable, while the overall capital position of banks has improved. The short-term liquidity of Italian banks, as measured by the Liquidity Coverage Ratio (LCR), remained comfortable at system level over the last year and equalled to 197% in February 2021. It therefore stands markedly above the required level of 100% ([9]). The comfortable liquidity position is, *inter alia*, attributable to the Eurosystem refinancing operations providing abundant liquidity and to the increase in deposits, both by companies and households. The capitalisation of Italian banks increased over the last years, putting them into a better position to withstand shocks compared to the time prior to the double-dip recession (Graph 4.1(f)). According to the Bank of Italy, the common equity tier-1 (CET1) ratio equalled on average to 15.5% of risk weighted assets (RWAs) as of December 2020, indicating a 160 basis points increase compared to the end of 2019. In this respect, European and Italian banks benefitted from supervisory and capital relief measures. These comprise, *inter alia*, the deactivation of the Capital Conservation Buffer, the Pillar 2 Guidance and the recommendation to not distribute dividends or buying back shares. Moreover, further flexibility on capital buffers has been granted under the CRR II quick fix. As such, the SME supporting factor, the regulatory treatment of software investments and the relief measures on loan loss provisions under IFRS9 will temporarily reduce capital erosion. The future evolution of the capital buffers of Italian banks will depend on both banks' profitability, which is required for the organic built up of capital, and the degree of deterioration of asset quality, which bears the risk of a depletion of capital buffers.

Insolvency proceedings

Insolvency proceedings in Italy remain lengthy compared to other EU economies, while the implementation of the 2019 insolvency code has been postponed to September 2021. Insolvency proceedings in Italy have traditionally been lengthy, costly and have relied on the judicial courts to a large extent, regardless of value size. Thus, in international comparisons on the efficiency of insolvency frameworks, Italy ranks below other large EU economies. Italy adopted a major reform of the insolvency framework in 2019, but its entry into force was postponed from August 2020 to September 2021 due to the impact of the pandemic. In addition to the overhaul of the insolvency framework, alternative in-court and out-of-court arrangements have been introduced over the last years, but their impact has been rather muted so far. The timely implementation of the 2019 insolvency code coupled with improvements in the efficiency of the court system could be beneficial in order to cope with a potential upcoming increase in bankruptcies, while at the same time averting the new accumulation of private debt due to the pandemic. In addition to that, a review of the out-of-court settlement arrangements appears warranted, so as to identify areas in which further improvements may be necessary to incentivise the concerned parties to make enhanced use of such proceedings. This could also alleviate the workload of judicial courts and contribute to an increase in their efficiency.

([9]) According to the Bank of Italy, the Net Stable Funding Ratio (NSFR), which is not yet a binding requirement for European banks, stood at an average of 124% for Italian significant banks in December 2020.

Graph 4.1: **Thematic Graphs: Financial sector**



Source: EC based on ECB data

Source: EC based on ECB data

Source: ECB Bank lending survey

Source:EC based on ECB data

Source: EC based on ECB, Eurostat and IMF

Source: ECB Bank Lending Survey

Source: European Commission Services