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Italy

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European Commission
Directorate-General for Economic and Financial Affairs

In-Depth Review 2024

Italy

EUROPEAN ECONOMY

Institutional Paper 283

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In-Depth Review 2024

This in-depth review presents the main findings of the Commission's staff assessment of macroeconomic vulnerabilities for Italy for the purposes of Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances. It provides technical input to the Commission for the Communication "European Semester – 2024 Spring Package" that will set out the Commission's assessment as to the existence of imbalances or excessive imbalances in Italy. That Communication will be published in June 2024. The current version has been presented and discussed with the Member States in the Economic and Political Committee of the Council.

This publication reproduces staff working document SWD(2024) 104 final, that was discussed with Member States in the Economic and Political Committee of the Council on 18 April 2024.

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1. INTRODUCTION

This in-depth review (IDR) analyses the evolution of Italy's vulnerabilities related to high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in financial markets, and possibly newly emerging risks. Italy was identified with excessive imbalances in 2023, over the last annual cycle of surveillance under the Macroeconomic Imbalance Procedure. This year's IDR, which follows the 2024 Alert Mechanism Report (AMR) published in November 2023, assesses the persistence or unwinding of the vulnerabilities identified last year, potential emerging risks, and relevant policy progress and policy options that could be considered for the future ([1]). Given the size of the Italian economy and its interlinkages with the other EU Member States, these vulnerabilities have a cross-border relevance.

The vulnerabilities in Italy are analysed in a macroeconomic context of sluggish growth, decelerating inflation and substantial remaining global uncertainties ([2]). In the light of high inflationary pressure, weakening global demand and high uncertainty, GDP growth slowed down to 0.9% in 2023, compared to 4.0% in 2022, and is forecast at 0.7% in 2024 and 1.2% in 2025. This growth outlook reflects weakening domestic demand in 2023-2024, in light of higher interest rates and tighter financing conditions, with a rebound expected in 2025, supported by investments under the recovery and resilience plan (RRP). Headline inflation started to moderate in 2023, to 0.5% in December (i.e., well below the 2.9% euro-area average) and remained below 1% in January and February 2024. The pass-through from energy and food prices to other goods and services occurred with a lag, pushing core inflation above headline inflation in the fourth quarter of 2023. In this context, wages are expected to catch up gradually with prices, with nominal compensation of employees accelerating in 2023, albeit less than elsewhere in the EU, and expected to rise more than prices in 2024 and 2025. In annual terms, inflation was still 5.9% in 2023, but is forecast to fall to 2.0% in 2024 and then rise modestly to 2.3% in 2025.

High integration with other major European and non-EU partners makes Italy prone to spillovers resulting from economic developments in these economies ([3]). The Italian economy is highly dependent on imports of German and French goods and services, though most of the value added in Italian imports is generated in Germany and China. Germany, France and the US are the major destinations for Italy's exports, both in terms of the total value of exports and in terms of value added in exports ([4]). As is the case for all large Member States, Italy's interlinkages to non-EU

([1]) European Commission (2022), European Semester Spring Package 2022, COM(2022) 600 final; European Commission (2023), Alert Mechanism Report 2024, COM (2023) 902 final; and European Commission (2023), Alert Mechanism Report 2024, SWD(2023) 901 final.

([2]) Figures for GDP growth and inflation come from the Commission Winter 2024 Interim Forecast (European Economy, Institutional Paper 268). All other forecast data used in the in-depth review come from the Commission 2023 Autumn Forecast (European Economy, Institutional Paper 258), unless stated otherwise, and all calculations are carried out using these data to ensure the coherence of their various components. The cut-off date for the data for the preparation of this in-depth review was 19 March 2024. Actual out-turn data that have become available after the Autumn and Winter Interim forecasts, and before the cut-off date for the in-depth review, are used and supersede figures from those forecasts.

([3]) In the context of the multiple disrupting shocks that affected the world economy and the EU in the past few years, Commission Services have run an exercise to estimate the spillovers and the degree of exposures of Member States' economies to various partners and industries, in terms of nominal trade, value-added trade, inflation and financial assets. See European Commission Institutional Paper 2024 (forthcoming) - Economic spillovers and exposures in the EU.

([4]) Germany and France account for 15.4% and 9.3% of Italy's imports, while Germany, France and the US account for 13.2%, 10.6% and 9.5% of Italy's exports, respectively, for 2021.

partners, whether directly or indirectly, are high; because of this, geopolitical and trade tensions appear to pose a non-negligible risk to its economy.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

The Italian economy has long been marked by high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in the financial sector. Italy's public debt-to-GDP ratio has markedly declined in recent years on the back of high real GDP growth and inflation. However, amidst high budget deficits, it has remained a major vulnerability for the Italian economy. The corporate-sovereign-bank nexus remains significant, although some progress has been achieved in recent years and bank liquidity buffers mitigated the associated vulnerabilities. Productivity growth has remained low for a long time, reflecting persistent structural shortcomings, and thereby hampering economic growth and public debt deleveraging. Labour market conditions have continued to improve, without translating into wage pressures so far. While risks pertaining to banks' asset quality and funding costs could materialise with a delayed impact, the banking sector's enhanced resilience and overall robustness are important mitigating factors. This chapter assesses how these vulnerabilities have evolved since last year's in-depth review.

Assessment of the gravity, evolution and prospects of macroeconomic vulnerabilities

Public debt

Italy's government debt ratio has decreased over recent years from a very high level, but it is projected to increase slightly in 2024 and 2025. Italy's public debt-to-GDP ratio peaked in 2020 at 154.9% of GDP, up from 134.2% of GDP in 2019. Over the subsequent 3 years, the debt ratio declined markedly to 139.8% of GDP in 2023 (137.3% according to data released by the Italian National Institute of Statistics on 1.3.2024) ([5]) mainly due to a strong rebound in real GDP growth and inflation. During this time, government deficits remained large, on average at around 8% of GDP each year in the 2020-2023 period. Despite this recent decline, the debt ratio is still above the pre-pandemic level, which was already high. This year, the debt ratio is projected to depart from its downward path and to edge upwards, reaching 140.9% of GDP by the end of 2025, with government deficits at 4.4% and 4.3% of GDP in 2024 and 2025, respectively, according to the Commission's 2023 Autumn Forecast. The expected worsening of the debt dynamics follows a debt-increasing stock-flow adjustment due to the delayed impact of 'payable' tax credits related to the 'Superbonus'

([5]) On 1.3.2024, the Italian National Institute of Statistics (Istat) released general government data for 2023, including revised data for preceding years. On the basis of Istat data, Eurostat will publish validated government finance statistics in its release of 22.4.2024.

scheme for housing renovation, as well as only a gradual improvement of the primary balance, and a less favourable economic growth-interest rate differential (Graph 2.2 a) ([6]).

High public debt remains a major vulnerability for the Italian economy. In combination with the increased borrowing costs following monetary policy normalisation, the high debt stock implies projected debt servicing costs above 4% of GDP this year and next. This reduces the resources available both for countercyclical policies to cushion negative economic shocks and for growth-enhancing measures. The extension of the debt stock's residual maturity over the years 2014 to 2021 has so far cushioned the increase in interest expenditure. However, during the past 2 years, the maturity of securitised debt shortened somewhat, stabilising at around 7 years at end-2023, which is less than the euro area's 8-year average ([7])([8]). Higher-than-expected interest rates would eventually weigh on both the deficit and GDP growth, thus representing a risk of rising debt ratios over the medium term. In turn, risk-mitigating factors include relatively stable government financing sources, with an increasing share of fixed-rate securities, together with a declining share of foreign debt holders.

Risks to fiscal sustainability are overall low in the short term, high in the medium term, and medium in the long term according to the Commission's debt sustainability framework ([9]). The Commission's early-detection indicator (S0) does not point to major short-term fiscal risks. Government gross financing needs in 2024 and 2025 are expected to average over 25% of GDP per year. The debt sustainability analysis for Italy shows that, under the baseline scenario, the government debt-to-GDP ratio is projected to remain at a high level in the medium term, increasing to around 148% in 2029 and to around 164% in 2034 (see Box 1 for more on the medium-term risks to fiscal sustainability). Over the long term, the Commission's fiscal gap indicators (S1 and S2) show that the risks stem mainly from Italy's unfavourable initial budgetary position and high debt level.

Competitiveness and productivity growth

After contracting in 2023, labour productivity is expected to grow modestly in 2024-2025. Increasing productivity growth is crucial to structurally support GDP growth, including to reduce Italy's debt burden, especially in a context of a declining working age population. Labour productivity per head, after a stagnating decade, went down by 7% in 2020 due to labour hoarding and the significant recession caused by the COVID-19 pandemic, then up by 7.4% in 2021 and a further 2% in 2022 thanks to a robust output rebound. It is estimated to have fallen marginally in 2023 and then to return to moderate growth in 2024-2025, in line with the EU average ([10]). Over the longer term

([6]) The national account recording of payable tax credits implies that they are recorded as expenditure when earned. However, the timing of the impact on deficit and debt is not fully aligned, thus giving rise to a debt-decreasing stock-flow adjustment when the payable tax credits expenditure is recorded, and to a debt-increasing stock-flow adjustment when the related lower tax revenues will impact on the debt but not on the deficit.

([7]) Securitised debt in the case of Italy accounts for more than 80% of total public debt.

([8]) If loans received under the SURE and NextGenerationEU programmes are taken into account, the average maturity was 7.3 years in the 2021-2023 period. The average maturity of total debt has stabilised at around 7.7 years in the 2021-2023 period, from an average of 7.4 years in the 2016-2020 period.

([9]) The results presented here are based on the debt sustainability analysis published in the Debt Sustainability Monitor 2023 (European Commission, Institutional Paper 271), which is based on the Commission 2023 Autumn forecast. The Debt Sustainability Monitor also includes information on the methodology of the Commission's fiscal sustainability risk framework.

([10]) As hours worked follow more closely GDP fluctuations, however, labour productivity per hour worked rose in 2020 and fell over 2021-2023.

(2000-2022), real labour productivity in Italy has decreased by 4%, while the EU average increased by 20% ([11]). Labour productivity increased in industry, but not as much as in the rest of the EU. The impact of changes in the sectoral composition was broadly neutral. Productivity growth in Italy has long been hindered by factors such as small firm size, relatively weak performance of large businesses, and slow human capital accumulation, all contributing to determining a low innovation capacity. Sizeable and persistent regional differences in productivity hinder the overall competitiveness of the country. All these factors translated into losses of competitiveness and export market shares (see thematic chapter). Firms with fewer than 20 employees generate 34.5% of the value added of the economy (EU 26.3%, Germany 23.5%, France 25%), while those with 250 employees or more, which have greater economies of scale and easier access to investment funding, account for just 38.5% (EU 47.5%, Germany 51.5%, France 56%). Italy trails behind the EU average on the share of tertiary graduates and that of doctorates in scientific and technical areas, though the latter has improved lately. In terms of its innovative capacity, Italy's gap with the EU on R&D spending widened in 2022, particularly in the business sector (less than 1% of GDP in Italy vs 1.5% in the EU), while the number of patent applications per capita is still well below the EU average, though slightly increasing. The recent rise in financing costs, affecting Italian firms more than their euro-area peers on account of their higher-than-EU-average reliance on bank lending and of the sovereign interest rate differential, is expected to drive a retrenchment in corporate capital spending, although construction investment still rose in 2023 due to the remaining tax incentives on housing renovation.

Productivity is expected to benefit from investments in the green and digital transitions and ongoing structural reforms. Even though primary energy prices went back to their long-term average levels, the protracted surge led some energy-intensive activities to close or relocate, while triggering new investment in energy-saving technologies. This trend is likely to continue, encouraged by policies promoting the green transition, but will require additional efforts to increase the supply of qualified workers as well as to mobilise risk capital. The ongoing structural reforms and still expanding investment projects supported by the RRP are expected to foster more favourable conditions to productivity growth.

Labour market

The labour market continues to face structural challenges with low participation rates, regional and gender disparities, and high youth unemployment. The participation rate (Y15-64) continued to rise in 2023, by around 1 pp. to 66.7%, remaining well below the euro-area average of 75.0%. Although the increase was similar for men and women, the participation rate of Italian women remains below 60% and still trails that of their European counterparts such as Germany, France and Spain, which all have rates for women above 70% (Graph 2.2 b). Participation rates among the younger generations are also much lower in Italy than in peer countries. As a share of the population, Italy has nearly twice as many people aged 25-34 outside of the labour force compared with Germany, France or Spain. At the same time, employment rates (Y20-64) rose to record levels, reaching 66.3% in 2023 and narrowing marginally the gap with the euro area (74.8%), for both men and women. The unemployment rate decreased by 1.9 pps between 2021 and 2023, for both men and women, and by as much as 7.1 pps for young people (Y15-24), although at 22.7% the youth unemployment rate remains well above the euro-area average (14.4%). Within Italy, regional disparities persist; employment rates in the south are over 20 pps lower than in the north, even more

([11]) It is worth noting that, for about one third of this period, Italy was in recession, largely during the sovereign debt crisis of the 2010s.

so for women (nearly 27 pps), and these gaps decreased by just a few decimal points in the last 2 years. The regional gap in unemployment narrowed by 1 pp. in 2023, but the unemployment rate in southern regions is still triple that of northern ones (double for those aged 15-24).

Firms hired more employees with permanent contracts and accepted wage increases to reduce workers' turnover. The number of employed persons grew by 1.8% in 2023, while hours worked increased by 2.3%. In 2023, one fifth of workers were self-employed, a category that includes traditional crafts and professions but also a large share of economically dependent self-employed. The number of self-employed went up by 1.3% last year, probably on account of tax incentives, after a two-decade-long decline in which it fell by nearly 20%. Out of the four fifths who are employees, 16% have a fixed-term contract, as against 14% on average in the euro area. Combined with the 18% who work part-time, the share of atypical work contracts remains high. However, open-ended contracts rose by 3.3% in 2023, i.e. faster than average, while the number of temporary contracts actually declined (-2.4%). At the same time, in 2023, the job vacancy rate remained high, around 2%, pushing employers to accept wage increases in order to retain workers. Contractual wages rose by 3.1% in 2023, while actual wages grew on average by 2.6%, as bonuses were not renewed and employment increased more rapidly in lower-wage sectors and occupations. Both growth rates, however, were well below the deflator of private consumption (5.2%), resulting in negative real wage dynamics for the second consecutive year. This is set to revert in 2024-2025, when most national multi-year wage contracts to be renewed are expected to incorporate part of the past inflation, while inflation is set to decline to very low levels.

Banking system

The Italian banking sector has made significant progress in recent years, with a continued improvement in asset quality and profitability. By September 2023, the gross non-performing loan (NPL) ratio further decreased to 2.8%, a substantial decline from its peak of 16.5% in 2014 (Graph 2.2 e). While the bulk of NPLs has exited bank balance sheets, freeing up capital for new, healthy lending, the stock of NPLs outside bank balance sheets still to be reabsorbed by the economy remains substantial. According to Banca Ifis, the outstanding stock of NPLs in the economy still amounted to EUR 306 billion in 2022, lower than its peak of EUR 361 billion in 2015 but much higher than the pre-financial crisis level of EUR 78 billion. Loans collateralised by commercial real estate that is subject of adjustment across the EU account for about 20% of bank loans to non-financial corporations (as of September 2023) and have a higher share of non-performing loans than other sectors. However, prudent provisions have been set aside and this ratio has been decreasing over time and only few of commercial real estate loans exhibit a high (above 80%) current loan-to-value ratio ([12]). Capitalisation levels of banks remain robust, with the total capital ratio and the Common Equity Tier 1 ratio at 19.7% and 15.7% respectively as of Q3 2023, higher than 2022 and well above the minimum regulatory requirements. Bank liquidity positions remain comfortable notwithstanding the repayment of EUR 146 billion, in June 2023, of the third series of targeted longer-term refinancing operations (TLTRO III). Bank profitability has further strengthened, with the return on equity reaching 12.7% in Q3 2023, primarily due to higher net interest income and lower provisions, which may not be sustained in the future.

Higher interest rates can also imply challenges for the financial sector. Over 2023, credit flows contracted, especially to non-financial corporations, as interest rates for both households and

([12]) With regard to real estate funds, they represent only a limited risk to financial stability as they are closed-end funds by legislation and not subject to the liquidity risk of high early redemptions.

non-financial corporations increased significantly ([13]) (Graph 2.2 f). This may affect the future repayment ability of borrowers, particularly for those with high debt-to-income ratios and a large share of variable-rate loans ([14]). Additionally, the cost of funding may increase for those banks that still have to repay TLTRO III or had to issue eligible instruments to meet their minimum requirement for own funds and eligible liabilities, especially given the increased competition from the government for household deposits. Finally, access to non-bank finance remains limited for non-financial corporations, and its relative cost has been negatively affected by the ongoing monetary tightening. The values of annual initial public offerings and corporate bond issuances both fell as a share of GDP to 0.2% and 0.9% respectively in 2022, compared to 0.3% and 1.9% in 2021, while venture capital investment stood at 0.037% of GDP over the same period.

While some progress has been achieved in addressing the corporate-sovereign-bank nexus, the exposure of the banking system to the government remains significant. Loans backed by government guarantees further deepened the nexus between banks, corporates and the sovereign in the wake of the COVID-19 pandemic and the recent energy crisis. However, as the interest-only grace period ended, an increasing share of principal from these loans has been repaid and was expected to reach 45% by end-2023 according to the Bank of Italy. Looking ahead, the deterioration rates for these loans remain low but higher than for market loans. Bank exposure to domestic sovereign debt amounted to 9.5% of total assets at end-2023, lower than the level reached at end-2020 (10.9%), but still high by historical standards. In September 2023, some 29% of the government holdings of significant banks was held at fair value and some 71% at amortised cost, limiting their vulnerability to short-term market movements (unless they are subject to forced sale). Although rising interest rates have led to the build-up of unrealised losses from this portfolio, their potential impact, net of hedging, was estimated by the Bank of Italy to be around 2% of risk-weighted assets. However, given the abundant liquidity buffers, the likelihood of these losses materialising is limited.

Box 1: Italy: Medium-term government debt projections

This box summarises government debt to GDP projections for Italy over the next decade, based on the latest government debt sustainability analysis conducted by the Commission.

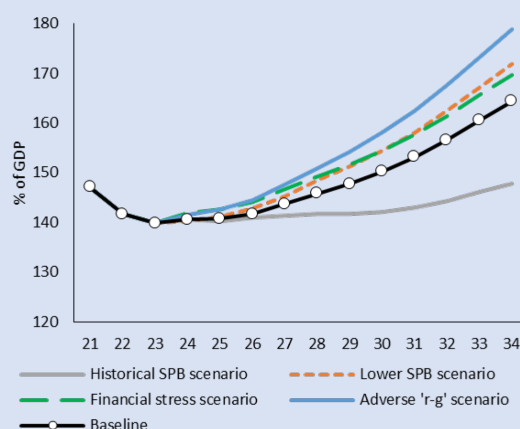
In Italy, medium-term risks to fiscal sustainability are high overall ([15]). The debt sustainability analysis for Italy shows that, under the baseline scenario, the government debt-to-GDP ratio is projected to remain at a high level in the medium term, increasing to around 148% in 2029 and to around 164% in 2034 (Graph 2.1). That projection assumes that, with unchanged policies, the structural primary balance (excluding changes in the cost of ageing) remains constant at a deficit of 0.9% of GDP in 2024 until 2034. The debt projection reflects only until 2025 a favourable (although declining) snowball effect. Real GDP is expected to grow by 0.4% on average over 2025-2034. Government gross financing needs are expected to remain high over the projection period, averaging around 27% of GDP, and somewhat more than that over the second half of that period. The baseline projections are stress-tested against four alternative scenarios to assess the impact of changes in key assumptions. All but one of those scenarios would lead to a faster increase in debt relative to the baseline, with the largest increase in debt due to the adverse interest rate-growth differential scenario. Stochastic projections point to a large degree of uncertainty.

([13]) Credit flows to domestic households and non-financial corporations contracted from 1.2% of GDP in Q1-2022 to -4.8% of GDP in Q3-2023 (annualised figures).

([14]) Bank of Italy, Financial Stability Report 2/2023: In a baseline scenario consistent with the latest macroeconomic forecasts, the share of debt held by vulnerable firms would rise modestly at the end of 2024. In a particularly adverse scenario, characterised by very negative changes in profitability and in the cost of debt, the share would rise more markedly, nevertheless reaching a level far below that recorded during the previous crises of 2008-2009 and 2011-2012.

([15]) The results presented here are based on the debt sustainability analysis published in the Debt Sustainability Monitor 2023 (European Commission, Institutional Paper 271), which was based on the Commission 2023 Autumn Forecast. See notes to Graph 2.1 for more details on the four scenarios used.

Graph 2.1: **Government debt projections based on scenario analysis for Italy (1)**



(1) The baseline projection is stress-tested against four alternative scenarios to assess the impact of changes in key assumptions: 'historical SPB scenario': the structural primary balance (SPB) gradually converges to its historical 15-year average; 'adverse 'r-g' scenario': the interest-growth rate differential is 1 pp. higher than in the baseline; 'lower SPB scenario': SPB level permanently lower than in the baseline as from 2024; 'financial stress scenario': temporarily increase market interest rates by 2.4 pps in 2024.

Source: Eurostat, Ameco, Commission calculations.

Assessment of MIP-relevant policies

While some recent fiscal policy measures go in the right direction, the overall set of measures introduced in recent years puts a permanent burden on public finances. Over the 2020-2023 period, public finances were burdened by the measures to mitigate the economic and social impact of the pandemic crisis and the increase in energy prices. These measures were wound down by the end of 2023. Nevertheless, and despite the discontinuation of expenditure on tax credits for the energy-efficient renovation of residential buildings, the budget deficit is expected to remain high and well above the 3% reference value. This is because measures with a permanent impact on public finances were enacted in recent years, including, among others, early retirement schemes, a revision of the tax-benefit system and a reduction of social security contributions in poorer regions. The budget for 2024 includes several new and extended fiscal measures, most of them with a permanent effect. Furthermore, several structural trends are expected to weigh on expenditure in the coming years. These include higher spending for public wages, pensions (also given their indexation to inflation and the population ageing), health services and funding costs. Moreover, depending on the final formulation and on its implementation, the reform of regional differentiated autonomy, currently under discussion in parliament, risks jeopardising the government's ability to keep national public spending under control. At the same time, the national framework for the annual spending review has been enhanced and its annual savings targets have been incorporated in the budget cycle, starting from 2023. In addition, risks related to the high number of guarantees granted during the pandemic have decreased significantly. Cuts to the high labour tax wedge have been prolonged and extended only to 2024, as a prolongation to 2025 is not yet financed. By reducing income taxation for low- and medium-income earners, these tax wedge cuts are a first, limited implementation step of the 2023 enabling law for a general tax reform. In addition, previous policies against tax evasion, including those implemented under the RRP, have contributed to significantly improving tax collection and compliance, and further positive results are expected in the medium term. At the same time, depending on how it is implemented, the recently introduced simplified tax settlement system, whereby self-employed workers can agree *ex ante* their tax liability with the tax administration, could pose tax compliance risks.

Further action is needed to reduce the public deficit and debt ratios. Overall, to strengthen Italy's debt sustainability, it is crucial to pursue prudent budgetary policies with adequate primary

surpluses, coupled with additional efforts to enhance the efficiency and quality of public spending to preserve investment and to resolutely implement measures to improve tax compliance. A growth-enhancing reform and investment agenda, including an effective implementation of Italy's RRP, which aims at lifting potential growth and making the economy more productive, would further support a decline of the public debt ratio. In addition to RRP reforms, public debt reduction would benefit from further progressing with growth-enhancing tax reforms, reinforcing the sustainability of the pension system by avoiding temporary measures that ease early retirement, and measures to strengthen and simplify Italy's fiscal framework, including by fostering transparency, accountability and fairness.

A timely and effective implementation of the recovery and resilience plan is essential to realise its full potential to enhance competitiveness and productivity. As a key part of the recovery and resilience plan, Italy adopted the annual competition law package and its implementing acts. This legislative package plays a pivotal role in reducing entry barriers for firms, in enhancing competition in several industries such as energy, local public services and transport, and in modernising rules on merger control and market surveillance. To further enhance productivity in private services and microenterprises, it would be important to consider reforms aimed at increasing competition in regulated professional services. To strengthen innovation, it would also be important to support a stronger partnership between research institutions and businesses. The recent reform of the Industrial Property Code under the recovery and resilience plan is a positive step towards facilitating the transfer of technology from universities to the corporate sector. Given the relatively low weight of large corporates in the Italian economy, the government could consider a national strategy for unicorns in order to support the emergence of new large and more productive companies with higher growth potential. The revised recovery and resilience plan encompasses a EUR 36.5 billion incentive package designed to support the green and digital transitions of businesses and to reduce energy costs via energy efficiency improvements. Complementary to this incentive package, the national parliament has passed the Mandate Law, empowering the government to streamline and rationalise firms' incentives to improve the business environment and to focus national resources on the most effective policy instruments. These new initiatives complement the ongoing implementation of structural reforms in the areas of justice, public procurement, public administration, payment delays and public employment, as well as secondary and tertiary education, which would significantly improve the growth potential of the country. Programmes supported by cohesion policy funds are set to invest over EUR 6.9 billion for growth and competitiveness of SMEs and over EUR 6.3 billion for enhancing research and innovation.

The RRP includes measures to increase skills and participation rates and the government has adapted the social safety net, mainly aiming at an increased focus on labour market re-entry. The National Programme for the Guaranteed Employability of Workers (GOL) and the National Plan for New Skills, adopted in 2021, aim to raise labour activation and to facilitate job transitions by reducing skills mismatches. As of 31 January 2024, according to the Italian authorities, more than 2 million beneficiaries of the GOL programme received personalised assistance, with more than half of these receiving services of job reintegration ([16]). A 3-year plan to strengthen public employment services (PES) was also adopted in 2021; by mid-2023, about 250 PES centres had started their activities, including to strengthen their IT systems and train staff. Reforms to enhance the vocational training system and the technical and professional institutes, adopted in 2022, are expected to support students' transition from education to the labour market and to bridge

([16]) Italian National Agency for Active Labour Market Policies (ANPAL) note monitoring the implementation of the Workers Employability Guarantee (GOL) programme:
https://www.anpal.gov.it/documents/552016/1309678/Nota+GOL+n.+14+Focus+ANPAL+n.+169+-+dati+al+31dicembre2023.pdf/d072616e-936e-d0f9-6193-bb41fb1f5571?t=1706534727814.

mismatches between supply and demand of young workers. To reduce regional divides and skills mismatches, it will be crucial to ensure a balanced sectoral and geographical distribution in the implementation of these plans, and also to effectively integrate the most vulnerable workers. To promote labour market participation of women and caregivers, measures to strengthen the provision of affordable quality early childhood education and care (i.e., appropriate financing for operational costs) will be required beyond the infrastructural investments envisaged under the RRP. Regarding the social safety net, as of 2024 the previous minimum income scheme is replaced by a transfer scheme restricted to poor households in specific demographic categories (for example including a minor or a person with disabilities), but with a lower coverage. Poor households outside these categories receive a fixed benefit while participating in active labour market policies for a maximum and non-renewable duration of 12 months.

The full implementation of the insolvency framework and the emergence of a dynamic secondary market for non-performing loans provided the financial sector with effective tools to mitigate and address potential asset quality deterioration. Over the last decade, Italian banks were able to sell a significant portion of their NPL portfolios to servicers, fostering a dynamic secondary market. It is crucial to safeguard the progress made, uphold legal certainty, and fully implement the justice reform under implementation within Italy's RRP. Moreover, the further development of information systems to track and monitor out-of-court and in-court restructuring proceedings, as well as insolvency processes, would make it possible to properly assess the effectiveness of all available tools for the workout of non-performing debt, thereby better informing future policy reforms. Given that one fifth of outstanding bank loans to firms was backed by COVID-19 state guarantees as of June 2023, the government's successful phase out of the COVID-19 and energy liquidity schemes has been an important step. However, maintaining close and centralised monitoring and management of the guaranteed portfolio, coupled with a gradual reduction of guarantees to pre-pandemic levels, is advisable. Also, the revised version of the new bank levy encouraged several banks to increase their capital reserves, further bolstering the soundness of the banking system. Finally, while the national promotional bank's support has played a valuable role in developing the venture capital market, its size remains relatively small. Attracting more institutional investors remains a crucial challenge and the possibility to require a minimum investment quota could be explored.

Further efforts to promote growth-friendly fiscal consolidation and to implement an effective investment and growth strategy can reduce long-standing vulnerabilities. Low productivity growth and labour market weaknesses undermine Italy's ability to reduce its high government debt. As set out above, measures in the RRP to increase competitiveness, productivity and labour market participation can help improve Italy's debt sustainability. At the same time, there remains scope for further measures, e.g., by boosting R&D and bringing research and businesses closer together, as well as addressing skills gaps and the remaining barriers to labour market participation for women and young people. Measures aimed at improved monitoring and management of existing guarantees, NPL stocks, and restructuring proceedings and insolvency processes could support the stability of the financial sector.

Table 2.1: **MIP-relevant policy progress in Italy**

Vulnerability	Policies enacted since January 2023	Policies in progress since January 2023
Public debt	Release of pre-populated VAT tax returns to improve tax compliance. Inclusion of an annual spending review in the budget cycle. First implementation steps of the 2023 enabling law by reducing income tax for low and medium earners, introducing measures on tax compliance and tax assessment, including a simplified tax settlement, and measures on international taxation. Reduction of employee social security contributions. Repeal of the possibility for companies to deduct part of the notional return on new injections of equity capital from taxable income.	
Productivity and competitiveness	The public administration reform is now in force. The reforms concerning the judicial system, specifically civil and criminal justice, have been adopted. A number of reforms have been adopted to improve the primary, secondary and tertiary education systems. In 2022 and 2023, the government adopted the annual competition law.	Investments to improve educational outcomes, digitise the public administration and increase the efficiency of the judicial system are being implemented. As part of the revised RRP, the parliament adopted a mandate law to rationalise incentives for firms. RRP measures included the adoption of a new industrial property code and the abolition of the professor privilege.
Labour market participation and unemployment	Implementation of the Guaranteed Employability of Workers (GOL) programme reaching more than 1.3 billion beneficiaries. Activation of more than 250 public employment service centres and the strengthening of their IT systems and training of staff.	Adoption of the secondary legislation to support the full roll-out of reforms to enhance vocational training systems and to strengthen technical professional institutes. Awards of contracts at local level for the investment in childcare services to support female labour market participation.
Financial sector	As part of the RRP, the adoption of the insolvency framework reform was completed with primary and secondary legislation. The energy-related liquidity schemes of the Temporary Crisis Framework expired in December 2023. The 'Garanzia cartolarizzazione sofferenze (GACS)' scheme that facilitated the securitisation of non-performing loans was phased out in June 2022 and was not renewed.	Two legislative acts (the FinTech decree and the Capital Markets bill) have been adopted, aiming to facilitate access to non-bank financing. The 2024 budget law 213/2023 introduced: a) a mandatory requirement for firms to be insured against natural disasters, with the partial reinsurance of the Italian export credit agency SACE; and b) the establishment of a privately funded and governed guarantee fund for the life insurance sector.

	In July 2023, the government announced a new levy on banks' extra profits. In the parliamentary discussion, the provision was amended and allowed banks the possibility to opt out and to increase their capital reserves instead of paying the levy.

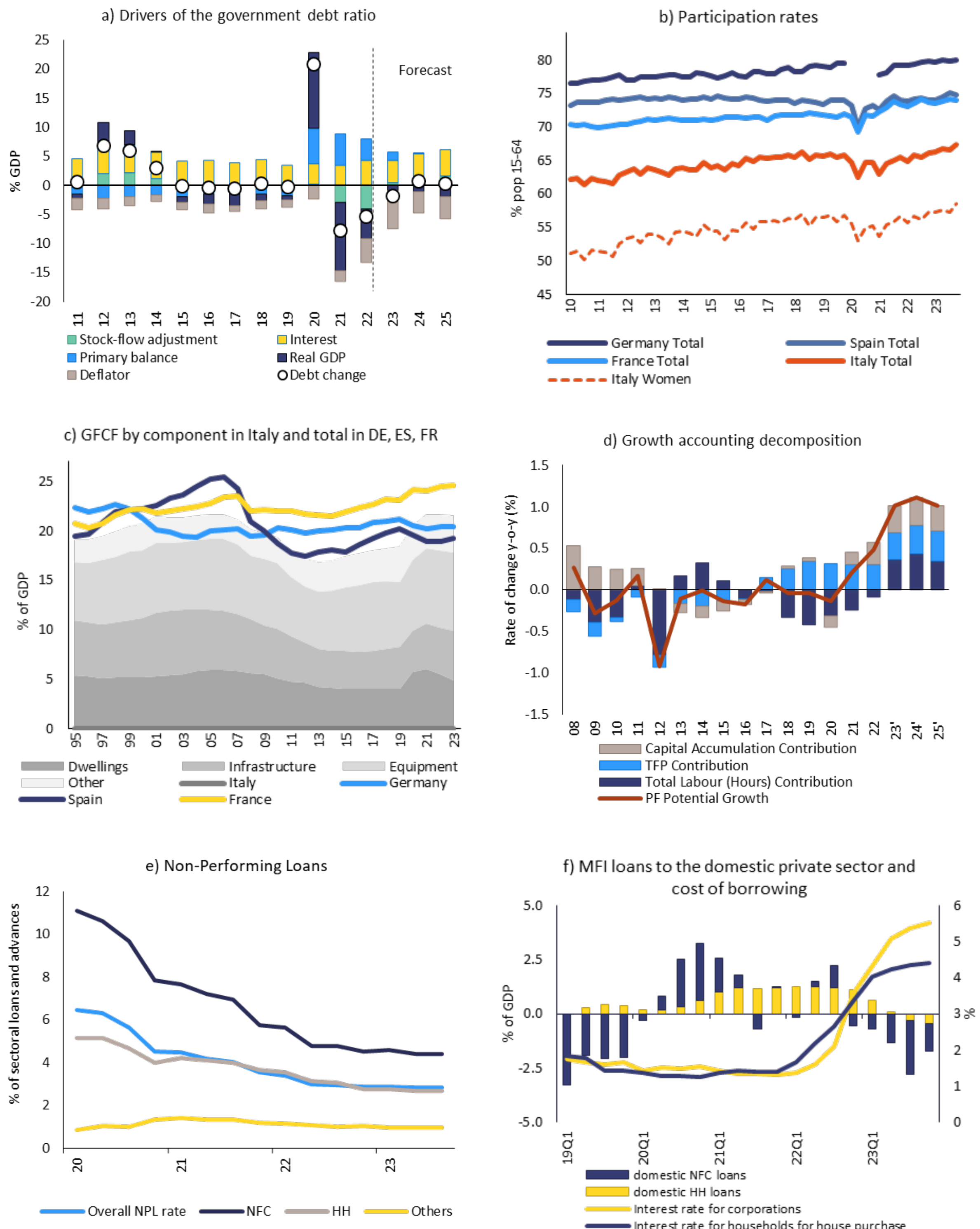
Conclusion

Italy continues to face vulnerabilities relating to the high government debt coupled with sizeable fiscal deficits and weak productivity growth in a context of labour market fragilities and some residual weaknesses in the financial sector. Italy's public debt-to-GDP ratio markedly declined by about 15 percentage points since its peak during the pandemic crisis, mainly due to strong nominal GDP growth, while the budget deficits remained large. However, with 139.8% of GDP in 2023 according to the Commission's 2023 Autumn Forecast, the public debt ratio is still high, and the downward trend is projected to reverse this year and next year. This is mainly due to a large debt-increasing stock-flow adjustment, still sizeable though decreasing, government deficits, and a less favourable nominal growth-interest rate differential. Moreover, sizeable debt servicing costs further limit the government's scope for growth-enhancing fiscal policies. Fiscal sustainability risks remain high over the medium term and medium over the long term. Since the pandemic crisis, annual productivity growth has fluctuated widely but around a flat trend, reflecting persistent structural shortcomings, while tighter financing conditions dampen the prospects for further capital deepening. Labour market participation rates have risen to record levels, though these are still low compared with euro-area peers, especially among the young, women and residents in the south of the country. Labour market conditions continued to improve for the third consecutive year and have not translated into wage pressures so far. Italian banks are still considerably exposed to sovereign credit risk and to the performance of state-guaranteed loans in their balance sheets. Bank asset quality has considerably improved, and profitability has risen along with normalising monetary policy, although banks may face challenges as the economic impact of the financial tightening unfolds further. A materialisation of risks stemming from these vulnerabilities could impact other Member States through various channels so that the vulnerabilities have cross-border relevance.

Policies to tackle the identified vulnerabilities made some progress, and further efforts are needed. While support measures related to the pandemic and the increased energy prices had been wound down by end-2023, increased pressure is expected to weigh on public finances in 2024-2025 as a result of permanent measures introduced in recent years. Further enhancing the efficiency and quality of public spending together with growth-enhancing investments and reforms as well as greater tax compliance, including a simplification of the tax system, will be important to put the high public debt on a firm downward path. The implementation of RRP measures continued, notably related to the education system and the business environment, with particular reference to competition and public procurement, to enhance the effectiveness of the public administration, with a focus on public employment, and efficiency of the judicial system. The efforts also include investments, particularly in innovation, digitalisation and sustainable mobility. Keeping up the pace of implementation of the RRP remains essential, including measures to support skills and labour market participation of women and young people. The progress made in implementing the insolvency reform and in the development of a secondary market for NPLs is expected to support a more efficient allocation of financial resources and to prevent further accumulation of NPLs. Italy is facing

challenges that would benefit from additional policy efforts, notably in the areas of the taxation and fiscal framework, labour supply in view of demographic challenges, and energy.

Graph 2.2: **Selected graphs, Italy**



Note: GFCF: gross fixed capital formation; TFP: total factor productivity; PF: production function; NPL: non-performing loans; NFC: non-financial corporations; HH: households; MFI: monetary financial institutions
Source: Eurostat, Ameco, ECB and European Commission calculations.

Table 2.2: **Selected economic and financial indicators (Part 1), Italy**

								forecast	
all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	2024	2025
Real GDP	1.1	-1.4	0.5	-9.0	8.3	4.0	0.9	0.9	1.2
p.m.: Real GDP (Winter 2024 interim Forecast)							*0.6*	*0.7*	*1.2*
Contribution to GDP growth:									
Domestic demand	1.0	-1.7	0.3	-7.6	7.1	4.7	2.0	0.7	1.3
Inventories	0.1	-0.2	0.1	-0.5	1.1	-0.2	-1.3	0.0	0.0
Net exports	0.0	0.6	0.0	-0.8	0.1	-0.6	0.3	0.2	0.0
Output gap (1)	1.9	-1.2	-2.3	-8.9	-1.3	1.5	1.2	1.2	1.6
Unemployment rate	7.6	8.5	11.5	9.3	9.5	8.1	7.6	7.4	7.3
Harmonised index of consumer prices (HICP)	2.3	2.4	0.7	-0.1	1.9	8.7	5.9	2.7	2.3
p.m.: HICP (Winter 2024 interim Forecast)								*2.0*	*2.3*
HICP excluding energy and unprocessed food (y-o-y)	2.1	2.1	0.8	0.5	0.8	4.0	5.5	3.1	2.7
GDP deflator	2.5	1.5	2.1	1.6	1.3	3.6	5.3	2.7	2.9
External position									
Current account balance (% of GDP), balance of payments	-1.0	-2.2	2.2	3.9	2.4	-1.5	0.2	0.9	1.0
Trade balance (% of GDP), balance of payments	-0.1	-0.7	2.9	3.6	2.2	-1.4	1.4	.	.
Primary income balance (% of GDP)	0.1	-0.3	0.3	1.3	1.3	0.9	-0.2	.	.
Secondary income balance (% of GDP)	-1.0	-1.2	-0.9	-1.0	-1.0	-0.9	-1.0	.	.
Current account explained by fundamentals (CA norm, % of GDP) (2)	-0.4	0.0	1.0	1.6	1.5	1.6	1.8	1.7	1.7
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (3)	-0.3	-0.2	-0.4	0.2	0.5	0.4	0.5	0.5	0.0
Capital account balance (% of GDP)	0.1	0.1	0.1	0.1	0.1	0.5	.	.	.
Net international investment position (% of GDP)	-16.7	-21.0	-13.0	0.9	7.5	4.6	.	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (4)	-9.4	-22.4	-12.5	0.4	5.6	1.6	.	.	.
Net FDI flows (% of GDP)	0.4	1.0	-0.1	1.1	1.4	-0.8	.	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	2.7	2.1	1.6	3.1	-0.9	2.5	3.3	3.7	3.4
Nominal compensation per employee	2.7	1.1	0.8	-4.1	6.3	4.8	2.4	4.3	4.4
Labour productivity (real, hours worked)	0.1	0.0	0.3	3.1	-1.7	-0.2	-1.4	0.7	1.0
Real effective exchange rate (ULC)	1.4	0.3	-0.7	-2.6	0.4	-0.9	-3.7	-0.7	0.9
Real effective exchange rate (HICP)	1.6	-0.4	0.3	0.3	-0.2	-1.4	1.7	.	.
Export performance vs. advanced countries (% change over 5 years)	.	-13.8	-6.7	-2.8	-2.7	-5.0	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	97.0	121.3	113.3	118.4	111.3	104.6	96.8	.	.
Household debt, consolidated (% of GDP)	32.8	42.4	41.6	44.9	42.5	40.6	37.7	.	.
Household debt, fundamental benchmark (% of GDP) (5)	10.3	11.2	16.5	23.8	25.1	26.3	28.4	.	.
Household debt, prudential threshold (% of GDP) (5)	35.0	35.0	35.4	35.3	35.5	36.2	36.6	.	.
Non-financial corporate debt, consolidated (% of GDP)	64.2	78.9	71.7	73.5	68.8	64.0	59.1	.	.
Corporate debt, fundamental benchmark (% of GDP) (5)	27.3	24.1	24.1	27.7	28.6	28.8	30.3	.	.
Corporate debt, prudential threshold (% of GDP) (5)	59.5	58.2	57.7	59.2	59.8	61.3	62.5	.	.
Private credit flow, consolidated (% of GDP)	9.3	2.9	-0.1	4.0	3.3	2.9	-1.4[e]	.	.
Household credit flow, consolidated (% of credit stock)	11.4	3.0	0.9	1.1	3.6	3.5	.	.	.
Non-financial corporate credit flow, consolidated (% of credit stock)	53.7	11.8	-3.5	14.7	7.2	5.5	.	.	.
Net savings rate of households (% of net disposable income)	8.7	4.6	2.9	10.2	8.1	1.8	.	.	.

(e) Estimate based on ECB quarterly data.

(1) Deviation of actual output from potential output as % of potential GDP.
(2) Current accounts in line with fundamentals ('current account norms') are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), 'Methodologies for the assessment of current account benchmarks', European Economy, Discussion Paper 86/2018, for details.
(3) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of the Commission's T+10 projections.
(4) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.
(5) Fundamental benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds identify a threshold above which banking crises become more likely. The fundamentals-based and the prudential benchmarks are calculated following Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.

Source: Eurostat and ECB as of 19.3.2024, where available; European Commission for forecast figures (2023 Autumn Forecast)

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

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-19	2020	2021	2022	2023	forecast 2024	2025
Housing market									
House price index, nominal	6.1	0.3	-1.4	1.9	2.6	3.8	.	.	.
House price index, deflated	3.6	-1.6	-1.9	1.8	1.0	-3.2	.	.	.
Overvaluation gap (%) (6)	9.9	17.5	-4.4	-7.5	-7.7	-8.4	-10.2	.	.
Price-to-income overvaluation gap (%) (7)	6.5	17.3	-1.3	-5.2	-7.6	-9.7	-13.6	.	.
Residential investment (% of GDP)	5.4	5.4	4.2	4.0	5.8	6.6	6.4	.	.
Government debt									
General government balance (% of GDP)	-3.1	-3.7	-2.4	-9.6	-8.8	-8.0	-5.3	-4.4	-4.3
General government gross debt (% of GDP)	105.6	117.6	134.4	154.9	147.1	141.7	139.8	140.6	140.9
Banking sector									
Return on equity (%)	9.7	-0.6	-0.6	0.8	5.4	8.9	.	.	.
Common Equity Tier 1 ratio	6.9	8.8	12.8	17.2	16.9	17.1	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (8)	4.4	8.3	10.6	3.5	2.7	2.2	.	.	.
Gross non-performing loans (% of gross loans) (8)	.	.	12.4	4.5	3.5	2.9	2.8	.	.
Cost of borrowing for corporations (%)	4.8	4.0	2.4	1.6	1.3	3.6	5.5	.	.
Cost of borrowing for households for house purchase (%)	4.3	3.8	2.3	1.3	1.4	3.3	4.4	.	.

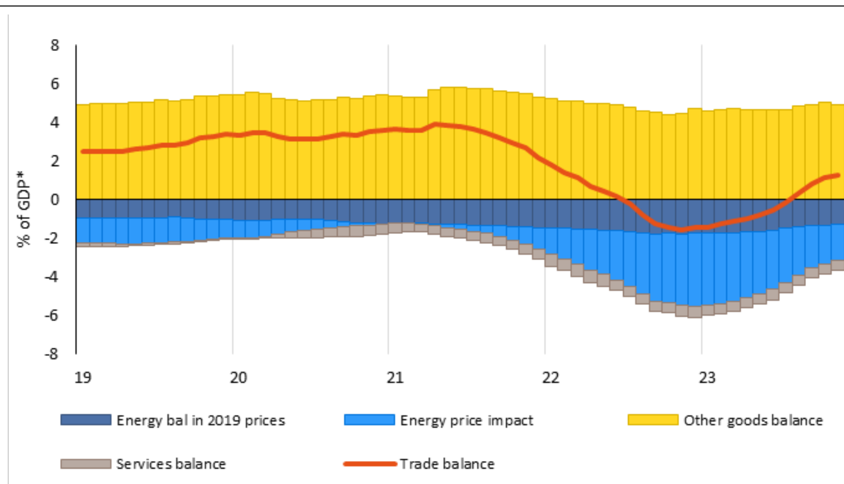
(6) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate, and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

Source: Eurostat and ECB as of 19.3.2024, where available; European Commission for forecast figures (2023 Autumn Forecast).

3. THEMATIC CHAPTER: EXPORT PERFORMANCE

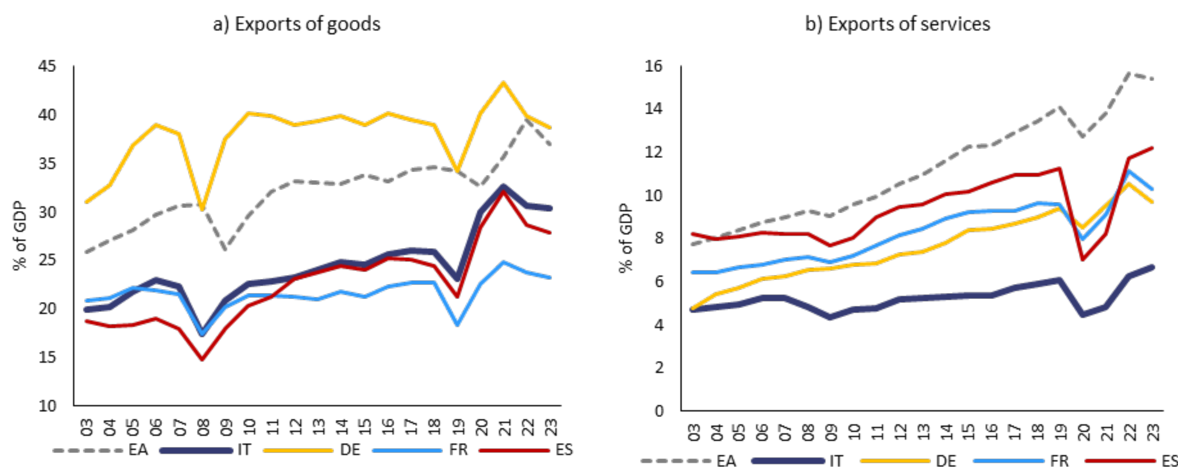
Italy's weak export performance is a drag on economic growth but does not put external stability at risk. This chapter describes Italy's export performance over the last two decades, taking a broad geographic and time perspective. Italy is a net exporter of goods (with net goods exports around 3% of GDP on average in 2012-2021), and a net importer of services (-0.2% of GDP), resulting in a positive trade balance. In 2022, however, the balance temporarily moved into negative territory due to the energy price surge, as Italy is a net importer of energy products (Graph 3.1). The trade balance turned positive again in 2023 and is expected to stay in surplus over 2024-2025, along with the current account. Italy's steadily positive net international investment position is a further supportive factor for macroeconomic stability.

Graph 3.1: **Trade balance**



Note: *12-month moving average.
Source: WTO and European Commission calculations.

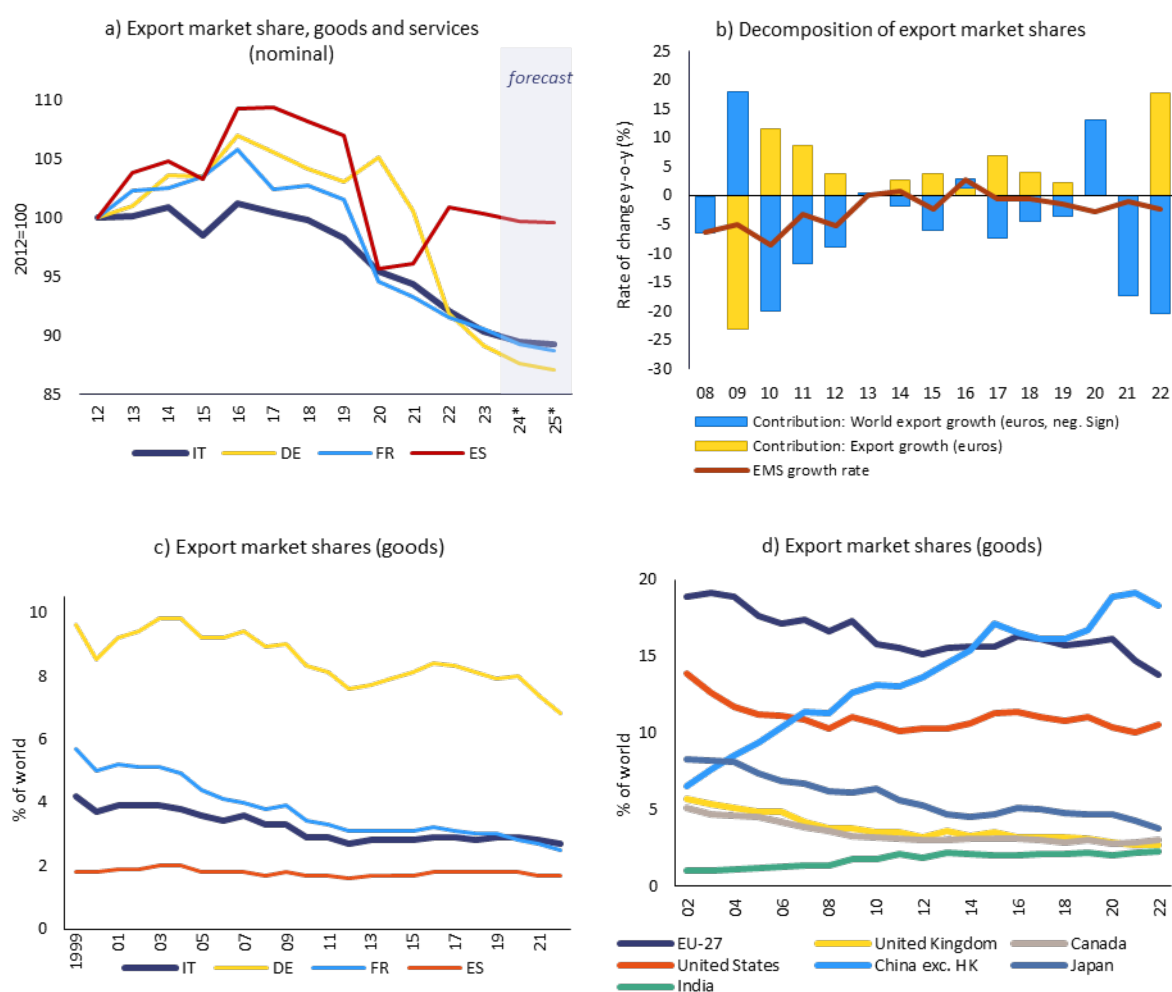
Graph 3.2: **Exports of goods and services: long-term trend**



Source: Eurostat, Ameco, ECB and European Commission calculations.

Italy has lost export market shares for the last 7 years, like several of its euro-area peers. Since 2021, the 5-year average loss of export market shares has exceeded the indicative threshold in the macroeconomic imbalance procedure scoreboard. However, this is not a particularly recent phenomenon, as Italy's share of global exports dropped even more rapidly in the early 2000s and over 2008-12. This long-term trend reflects, to a large extent, the increasing share of emerging economies in global trade. Exports of goods represented around a quarter of Italy's nominal GDP until 2020, then picked up in 2021-2022 owing mainly to high export (and import) deflators due to the surge in energy and commodity prices. In comparative terms, the value of exports (as % GDP) is in line with Spain, above France but well below Germany (Graph 3.3 c). Exports of services, hovering around 5-6% of GDP, are instead subdued compared with 10-12% in Italy's peers and nearly 16% in the euro area (reflecting the weight of tourism and of financial, professional and logistics services in smaller countries) (Graph 3.3 d). It thus seems appropriate to examine goods and services separately.

Graph 3.3: **Export market shares**



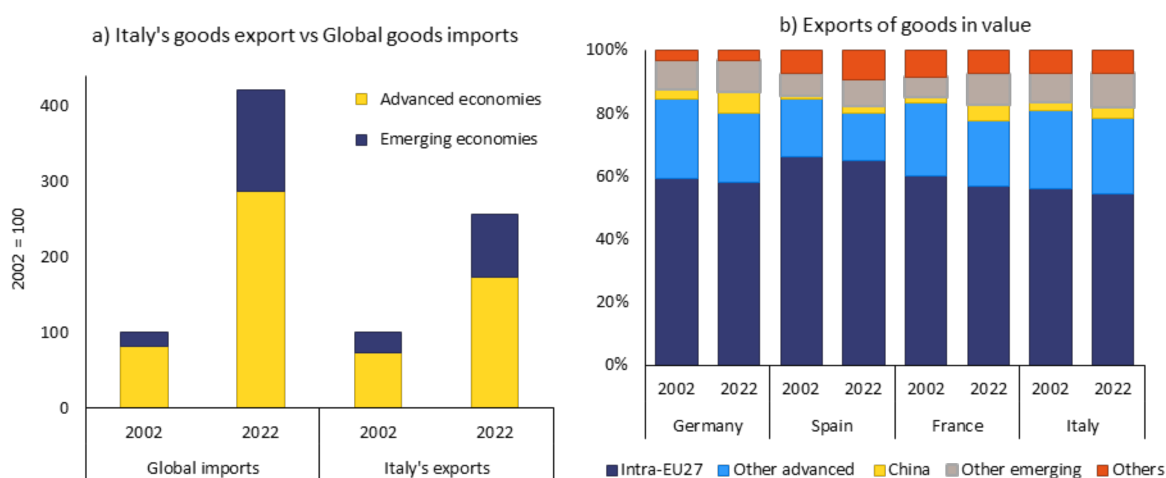
Source: Eurostat, Ameco, ECB and European Commission calculations.

Export of goods

Italy's share in global goods markets stabilised in the 2010s. Italy lost goods market shares around the turn of the millennium, when China entered the WTO and rapidly gained weight in global

trade. However, the trend stabilised after 2010, in line with euro-area peers (Graph 3.3 c). Compared with the growth of Italy's potential markets, as proxied by global imports that nearly quadrupled in the past two decades, the value of Italy's exports rose much less, by around 130% (Graph 3.4 a). While an unfavourable geographic specialisation plays a role, it does not appear to be the main reason. In 2022, 68% of Italy's goods exports went to advanced economies and 32% to emerging economies, which was broadly in line with the breakdown of global goods imports by origin. Two decades earlier, however, the emerging economies' share in Italy's exports was already 27%, against 19% in global imports. Because of this, Italy has not benefited much from the greater dynamism of emerging markets. In fact, within emerging markets, Italian exporters were focusing on closer destinations and were therefore less oriented towards China and other fast-growing Asian markets. After the global financial crisis, Italy's extra-EU exports of goods rose in line with those of the euro area.

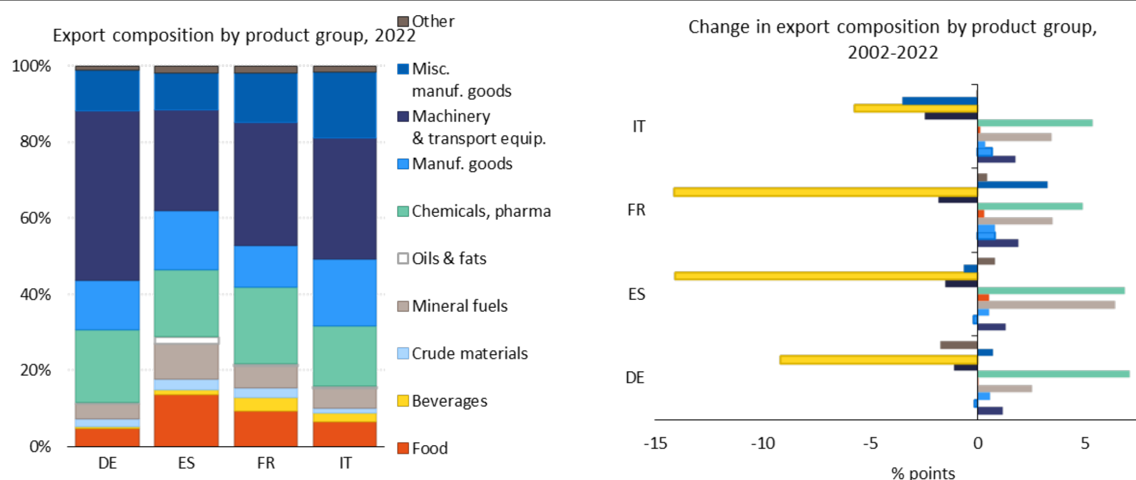
Graph 3.4: **Exports of goods: main destination areas**



Source: Eurostat, Ameco, CPB World Monitor (Global imports) and European Commission calculations.

The composition of Italy's exports by type of product evolved similarly to euro-area peers. At the most aggregate nomenclature level (SITC 1-digit), in 2022 Italy predominantly exported machinery and transport equipment (32%), manufactured goods such as metals, rubber and paper (18%) and miscellaneous goods including apparel, footwear, furniture, optical goods and precision instruments (17%; Graph 3.5 a). At the second level of aggregation, machines and vehicles top the ranking, together with pharmaceuticals, iron, steel and other metals, apparel and clothing. The product composition of exports changed gradually over the last two decades (Graph 3.5 b). In 2002, the structure of exports by broad product group was similar in Italy, Germany, Spain and France. By 2022, the proportion of machinery and transport equipment had fallen considerably in all four countries; that of manufactured goods also decreased, albeit slightly; and that of miscellaneous goods fell in Italy and Spain while rising marginally in Germany and more markedly in France. At the same time, the four countries saw significant increases in the share of exports of chemical products (including pharmaceuticals, which drove most of the rise in Italy and Germany) and energy products (largely due to price increases). In 2022, Italy exported a larger share of manufactured goods than France or Spain, but a smaller share than Germany, particularly for machinery, transport equipment, and chemical and pharmaceutical products. Food, beverages and tobacco grew proportionally more in France and Italy than in Spain and Germany, reaching shares of 13%, 9%, 15% and 5%, respectively, in 2022.

Graph 3.5: **Exports of goods: breakdown by product group**



Source: Eurostat and European Commission calculations

Italy's goods trade balance is back to positive territory. In 2022, the nominal balance of goods trade was stood at -0.9% of GDP, essentially due to the sharply worse terms of trade. It turned positive during 2023 and is forecast to stay above 1% of GDP over 2023-2025. The trade balance stayed positive for most of the past decade, as Italy typically exports more goods than it imports (around 3% of GDP on average over 2012-2021, in both value and volume terms).

Export of services

The performance of Italian firms in the international trade of services is much weaker than in goods. According to WTO data, Italy's share of total world exports halved from 3.4% in 2005 to 1.7% in 2022. Moreover, the country's exports of services in 2022 represented less than 5% of the EU-27 total, making Italy only the ninth-largest EU exporter (Ireland ranks 2nd and Luxembourg 7th). Over the past decade, the value of Italy's service exports rose more slowly than in any other EU Member State. In 2022, the services trade balance stood at -0.5% of GDP. Transport services recorded the largest deficit (-0.9% of GDP), spread across all main transport modes (sea, air, rail and road), while the biggest surplus was in travel (+0.9%), thanks to the recovery in tourism.

Italy exports its services predominantly to EU partners. In 2021, the share of exports to EU partners stood at 58% of its total exports, a share that – unlike in France or Germany – also rose significantly over the previous decade (from 48% in 2011; Graph 3.6 a). Such an increase is mainly due to growing trade with Luxembourg, Ireland and the Netherlands and is corroborated by the parallel increase in the export share of services heavily traded within multinational companies ([17]). In some of these services, such as financial and professional services, Italy runs a trade deficit, while in others (e.g., R&D) a small surplus.

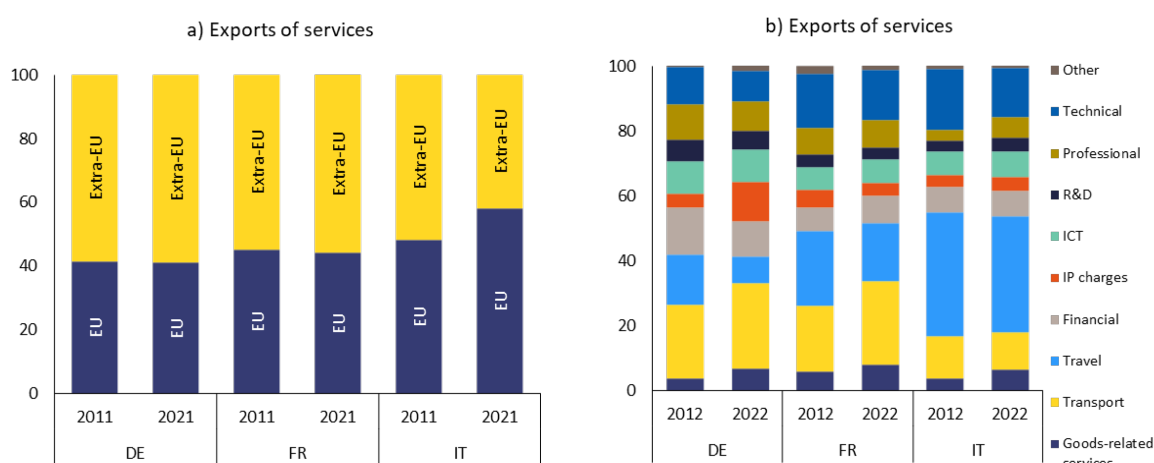
Tourism still has the largest share in Italy's services exports, though professional services are on the rise. The composition by type of service exported in 2022 highlights how travel services

([17]) These mainly consist of financial services (up from 3.7% in 2011 to 6.5% in 2021); professional services (legal, accounting, tax consulting and management, from 3.4% to 6.2%); charges for the use of intellectual property (3.5% to 4.3%); and R&D services (2.3% to 4.3%).

(for business or leisure, including passenger transport, accommodation, food-serving and other tourism-related services) represent a rather small and declining share of services exported by Germany and France, whereas in Italy they still account for over a third of the total (Graph 3.6 b). Transport has a much smaller (and decreasing) share in Italy's services exports compared with those two countries, while the proportion of professional services (legal, accounting, consulting, advertising and public relations) nearly doubled in 10 years, although it is still smaller than in France or Germany. Overall, the sectoral composition of services exports in Italy remained broadly unchanged over a decade, while the two other countries have successfully adjusted to changes in export markets. However, the growing imports of business services such as ICT, technical, professional, transport and logistics could have replaced domestic providers and in turn have enabled higher exports of goods.

Further diversification of services exports would help bridge the gap with competitors, and support market expansion. Italy's exports of services, as a share of GDP, are around half those of the other large euro-area countries, reflecting a combination of shorter geographic range (EU vs extra-EU) and focus on tourism. While the latter continued to recover steadily from the COVID-induced lockdowns even after 2022, providing a solid contribution to Italy's total exports, the narrower geographic and sectoral scope of exported services, as compared with competing countries, entails a smaller ability to capture growth opportunities arising from farther away (e.g., in transport) or from emerging activities (R&D, charges for the use of intellectual property). This could be linked to the small average size of Italian firms and their relatively limited outward projection in transport and specialised business services such as ICT and consulting.

Graph 3.6: **Exports of services**



Source: WTO and European Commission calculations.

Cost competitiveness

Macroeconomic measures of external cost competitiveness do not show a material weakening of Italy's position in recent years. Recent developments in the cost competitiveness of Italy vis-à-vis its peers do not explain the country's relatively weak export performance, which points to more structural causes – such as those highlighted in the previous sections – for the slow but steady downward slide in Italy's export shares. Among the main cost factors, labour does not appear to be a source of competitive losses. In 2023, unit labour costs relative to the euro-area average were 7.9% below the level of 2013, i.e., better than Spain, France or Germany. However, real effective exchange rates went up in 2023, after falling in 2021-2022. Over the past 4 years, these

rates rose less than in Germany but more than in the other two large euro-area countries. Among the other costs, financing rate differentials across the euro area have been compressed for several years; the recent rises, gradually incorporating monetary policy rate increases, do not yet appear to have particularly burdened exporting firms, which tend to be larger than average and have easier access to finance. Energy costs, by contrast, have had a greater impact on company bills, following the spike in gas and electricity prices from late 2021 through early 2023, which affected Italy relatively more than France or Spain for example, mainly due to its significant dependence on imported gas for electricity generation and industrial uses. Energy-intensive sectors have been penalised, although it is still unclear whether the output reductions have been recovered with the ensuing energy price normalisation, and thus to what extent Italian firms have permanently lost international market shares.

Conclusion

While external accounts do not entail major vulnerabilities, Italy would benefit from higher exports, which would also boost economic growth. Italy's trade balance was positive each year in the 2013-2021 period, and then turned negative in 2022 on account of the energy shock on imports. The European Commission 2023 Autumn Forecast projects it to return to positive territory over 2023-2025. The net international investment position (NIIP) improved steadily from -23.5% of GDP in 2013 to +7.5% in 2021. From the standpoint of macroeconomic stability, while risks are mitigated by broadly balanced external flows (current account) and stocks (NIIP), the main impact of export market share losses is forgone economic growth. Hence, a stronger participation in new export opportunities to emerging markets could support growth.

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