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In-depth review for Italy

Accompanying the document

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Italy

In-Depth Review 2023

On the basis of this in-depth review for Italy undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2023 Spring Package" (COM(2023) 600 final) that:

Italy continues to experience excessive imbalances. While there have been some improvements, vulnerabilities related to high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in financial markets, which carry cross-border relevance, persist. Italy's long-standing vulnerabilities have receded somewhat over recent years but remain significant and are not expected to unwind quickly. Persistent low productivity growth has been a key factor behind Italy's protracted weak economic growth, which slows down government debt deleveraging, dents employment opportunities and impacts banks' balance sheets. The government debt ratio further declined in 2022 along with the economic recovery. However, it remains high and constitutes a substantial fiscal sustainability challenge. The public debt ratio is forecast to further decline by 2024 but to increase in the medium term in the absence of consolidation measures. The government has implemented further measures to support the resilience of the financial sector and non-performing loans have significantly declined, but banks are still significantly exposed to the sovereign. Some progress has been made with policies to tackle imbalances, but sustained efforts are warranted and the implementation of the RRP remains the key policy priority as it includes comprehensive reforms and significant investments. Putting the high government debt on a firm downward path, in a context of rising debt servicing costs and rising age-related costs, requires a multipronged approach relying on prudent fiscal policies with adequate primary surpluses, growth-enhancing investments and reforms, greater tax compliance as well as an efficient use of national and European resources. Italy is facing challenges that, alongside a continued strong implementation of the RRP, would benefit from additional policy efforts, notably in the areas of taxation, fiscal framework and pension systems as well as in the areas of demography, labour market, and energy.

CONTENTS

1. Introduction 4
2. Assessment of macroeconomic vulnerabilities 5
3. Thematic chapter: labour market 18

LIST OF TABLES

Table 2.1: Selected economic and financial indicators (Part 1), Italy 16
Table 2.2: Selected economic and financial indicators (Part 2), Italy 17

LIST OF GRAPHS

Graph 2.1: Selected graphs, Italy 13
Graph 2.2: Components of gross fixed capital formation deflator growth and consumer price inflation 14
Graph 2.3: Impact of Italian value added inflations on EU partners' consumer price inflation 15
Graph 3.1: Employment rate, activity rate and unemployment 18
Graph 3.2: Employment rates and labour market slack 19
Graph 3.3: Job churning and ULC 20
Graph 3.4: Nominal and real wages 22
Graph 3.5: Annex on labour market 23

1. INTRODUCTION

In 2022, over the previous annual cycle of surveillance under the Macroeconomic Imbalance Procedure (MIP), the Commission identified "excessive macroeconomic imbalances" in Italy. ([1]) These imbalances were related to the high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in the financial sector, which carry cross-border relevance. The 2023 Alert Mechanism Report published in November 2022 concluded that an in-depth review (IDR) should be undertaken also this year for Italy with a view to assess the persistence or unwinding of imbalances. ([2]) The AMR concluded that in Italy concerns related to the high government debt-to-GDP ratio remain unchanged. Labour market weaknesses could increase again. Despite improvements in the banking sector, the risk of feedback loops is increasing due to the macroeconomic context and warrants close monitoring.

Italy's economic output fully recovered after the pandemic, then growth decelerated. GDP growth was 3.7% in 2022, down from 7.0% in 2021, amid the impact of Russia's aggression against Ukraine, which led to disruptions in the supply of some key commodities and sharp increases in their price. After contracting marginally in the final quarter of 2022 and rebounding swiftly in the first quarter of 2023, GDP is forecast to return to a more gradual pace of growth in the rest of the year, supported by public spending and still robust investment in infrastructure and equipment. While the rising cost of funding starts weighing on investment prospects, falling inflation is expected to relieve pressure on household consumption. Overall, real GDP is forecast to grow by 1.2% in 2023 and 1.1% in 2024. ([3]) Thanks to a swift reversal of last year's energy and food commodity price hikes, headline inflation is forecast to decrease to 6.1% in 2023 and 2.9% in 2024, with core inflation projected to remain slightly more elevated. The main downside risk to this forecast relates to potential further price shocks and the worsening of supply shortages that might delay the expected return to moderate inflation rates and thus affect domestic demand, with possible implications for the fiscal position.

This in-depth review presents the main findings of the assessment of macroeconomic vulnerabilities for Italy. The assessment is backed by the findings in the thematic section on labour market developments. The MIP assessment matrix is published in the 2023 Country Report for Italy. ([4])

([1]) European Commission (2022), European Semester Spring Package 2022, COM (2022) 600 final.

([2]) European Commission (2022), Alert Mechanism Report 2023, COM (2022) 381 final.

([3]) European Commission (2023), European Economic Forecast: Spring 2023, Institutional Paper 200.

([4]) European Commission (2023), Country Report Italy 2023, SWD (2023) 612 final.

2. ASSESSMENT OF MACROECONOMIC VULNERABILITIES

Gravity, evolution and prospects

Italy's high level of public debt remains a major vulnerability for the economy. Italy's public debt is characterised by a residual maturity of around 7 years at end-2022, which is below the euro area's 8-year average despite increasing between 2014 and 2021. ([5]) While this maturity has helped in cushioning the impact of the recent increase in government borrowing costs, the average cost of debt increased noticeably in 2022 and is forecast to remain broadly stable in the near future. This, together with high pension expenditure, reduces the resources available for countercyclical policies to cushion negative economic shocks as well as for productivity-enhancing spending and supporting the green transition to improve competitiveness and resource-efficiency. The Commission's assessment shows that Italy faces high fiscal sustainability risks over the medium term and medium risks over the long term. ([6]) Several reforms and investments included in Italy's Recovery and Resilience Plan (RRP) are expected to strengthen debt sustainability through higher growth and fiscal-structural reforms. However, to further support debt sustainability, the reform and investment agenda will have to be accompanied by prudent budgetary policies with adequate primary surpluses, also in light of a less favourable interest rate-growth differential.

Italy's government debt continued to decline in 2022 but remains at a high level. In recent years, the government deficits were impacted by a number of policy measures, including the higher-than-expected uptake of tax credits to support energy efficiency in residential buildings, together with a change in their statistical recording that shifted the deficit impact from future years to primarily 2021-22. Italy's public debt ratio reached its peak in 2020, at 154.9% of GDP, and started to decline afterwards, reaching 144.4% of GDP in 2022 (graph 2.1 a). The decrease was driven by a strong rebound in nominal growth and the phasing-out of pandemic-related fiscal measures, which more than compensated the budgetary costs of the fiscal measures adopted to counter the economic and social impact of the exceptional increase in energy prices. In the near future, the stock-flow adjustment, also related to the statistical reclassification of tax credits for building renovation works, is projected to provide a debt-increasing contribution. In contrast, favourable economic growth and improving primary balances, also due to the withdrawal of support measures, are expected to reduce the debt. As a result, Italy's public debt ratio is forecast to reach 140.3% of GDP by 2024, which is still above the already high pre-pandemic level.

Following weak growth over the last two decades, productivity dynamics have been volatile since the start of the COVID-19 pandemic. Weak labour productivity has been a drag for Italy's economic growth over almost two decades (graphs 2.1 b/c). From 2001 until 2019, GDP per hour worked virtually stagnated and GDP per employed person even fell. In comparison, over the same period labour productivity in both indicators increased by about 20 percentage points more in the EU. Key factors for this structural weakness were predominantly small firm sizes, which make it difficult to take advantage of economies of scale, and low investment, notably in

([5]) These maturities refer to securitised debt, which in the case of Italy accounts for more than 80% of total public debt.

([6]) See the DSA in the Commission Country Report 2023 for the latest risk classification and Debt Sustainability Report 2022 (April 2023) for methodological details.

intangibles. In turn, private domestic and foreign investment is hampered by a not particularly supportive business environment and by low average education levels. From 2019 until 2022, hourly productivity grew by 0.6% per year on average, slightly exceeding its weak average growth of 0.4% during the preceding decade. However, strong fluctuations in both economic output and labour input during the pandemic led to a marked volatility in productivity data during the past three years. The strong increase in hourly productivity by 3.1% in 2020 reflected the effectiveness of government support measures, including through the SURE scheme. In response to the abrupt drop in economic activity firms mostly opted to apply for short-time work schemes instead of laying off employees. Consequently, hours worked fell more than output. In turn, in 2021 hours worked recovered more strongly than output and thus productivity fell by 1%, followed by a small decline in 2022. Productivity is, however, forecast to rebound to a 0.5% average growth in 2023-24.

While financing conditions are tightening, the green transition, supply chain reorganisations, and the continued effective implementation of the Recovery and Resilience Plan constitute an opportunity to raise productivity. The higher funding costs on capital markets make investments in equipment or intangible assets less profitable for firms. Similarly, also high energy prices and supply chain disruptions, although recently easing, may make capital-intensive production processes more costly. As a consequence, the economy's capital deepening process could be at least temporarily impaired. However, structural adjustments to these changing conditions, including market exit of inefficient firms, and the transition towards greener energy sources could help increase efficiency in the medium to long term. Italy already made marked progress in geographically diversifying its sources of fossil fuels and in increasing its stock of renewable energy installations over the past years. Apart from reducing the risk of future energy price shocks, which makes capital-intensive production processes more attractive, the changed external environment and the energy transition could trigger firms to rethink their production processes more broadly. This, together with the required reskilling of the labour force, could eventually lead to structural improvements in the economy's total factor productivity. Policy measures included in Italy's RRP support this transition process.

The labour market continues to face structural challenges that dampen potential output, although the low employment rate, in particular of women, and the high youth unemployment are improving. In 2022, women's employment rate (20-64 years old) was 55%, against men's 74.7%. For both genders, the employment rates in Q4-2022 were slightly higher than the pre-pandemic Q4-2019 levels (respectively 75.2% vs 73.8% for men and 55.7% vs 53.8% for women). Regional employment differences remain substantial, with the rate in the North above 70% and that in the South below 50%. Among the younger generation (15-34), employment rates in the North are in line with the euro-area average (around 75%) while they are below 50% in the Southern regions. The youth unemployment rate (15-24) remains above 22%, well above the euro-area 14% average, although it is on a decreasing trend and lower than before the pandemic. Short-term indicators of labour market dynamics, such as the net balance between hiring and layoffs by private employers, continued to be positive in 2022 and accelerated in the first few months of 2023. Even though the recruitment with permanent contracts and the conversion of temporary into permanent contracts picked up markedly in 2022 and early 2023, fixed-term contracts remain the prevalent form of job on offer for new hires (around 75% of total recruitment). ([7]) The robust growth in all employment indicators is not expected to reverse in the near future, although the momentum is likely to slow down, in line with the reduced pace of economic expansion (see section 3 for more details).

([7]) Ministry of Labour and Social Policies (MLPS), Bank of Italy and National Agency for Active Labour Market Policies (ANPAL), The labour market: data and analysis, March 2023 (https://www.bancaditalia.it/pubblicazioni/index.html?com.dotmarketing.htmlpage.language=1)

Wage growth has not picked up in line with inflation, supporting price competitiveness but lowering real disposable income. The wage moderation displayed before the pandemic has not diminished in the subsequent recovery, with the surge in inflation not having been reflected much in wage contract renewals so far, and thus entailing losses in real labour-income and households' purchasing power. Real wages had fallen by around 5% after the 2008-13 crisis and have stagnated thereafter: as a result, they remain well below their level at the start of the millennium, while in the euro area they rose by some 10% over that time span. Given Italy's sluggish growth of labour productivity, persistent wage moderation has allowed preserving price competitiveness vis-à-vis its European peers.

The health of the Italian banking sector has strengthened since the global financial crisis and the improvement in asset quality continued in 2022, although challenges remain. The gross non-performing loan (NPL) ratio substantially decreased to 2.9% in Q3-2022 (graph 2.1 f) from a peak of 16.5% in 2014 but remains higher for Less Significant Institutions ([8]) and in Southern regions ([9]). However, roughly half of the stock of NPLs is made of unlikely-to-pay loans, which warrant closer oversight. Furthermore, banks have maintained reassuring capitalisation levels (Common Equity Tier 1 ratio of 14.7% in Q3-2022) and liquidity positions above regulatory requirements (Liquidity Cover Ratio of 190.2% and Net Stable Funding Ratio of 133%, in December 2022) ([10]). The normalisation of monetary policy also contributed to a rise in bank profitability with Return on Equity reaching 6.5% in Q3-2022. This positive trend was mainly driven by an increase in net interest income (+9.2% in Q2-2022 compared to Q2-2021). ([11]) Looking ahead, banks are expected to be able to cope overall with the challenges posed by the phasing out of the Targeted Longer-Term Refinancing Operations (TLTRO) funding, as around half of TLTRO III ([12]) will expire by June 2023. The slowdown in economic activity may weigh on borrowers' ability to repay loans and therefore negatively affect asset quality. The increase in the cost of lending for both non-financial corporations and households may weigh on credit demand, while the debt servicing cost of loans with variable interest rates has been increasing. However, the low debt level of the Italian corporate sector, its abundant liquidity and the strong profitability performance after the pandemic mitigate downside risks. ([13]) Finally, the Italian financial system remains predominantly bank-based and despite some progress in recent years, access to non-bank finance remains underdeveloped and concentrated in Northern regions.

The public guarantee and liquidity schemes were effective in supporting economic activity, but intensified the corporate-sovereign-bank nexus, which remains a challenge for the banking sector. While exposure to the domestic government ([14]) as a ratio of bank total

([8]) Bank of Italy, Financial Stability Report: The gross non-performing loan ratio for less significant institutions was 5.9% in December 2022.

([9]) Access to finance is more expensive for companies located in the South where banks report higher levels of NPLs. - Bank of Italy, No. 710 - The territorial gaps in the access of Italian firms to credit (26 July 2022).

([10]) Liquidity ratios (LCR, NSFR) have a regulatory requirement of 100%. The data on liquidity are provided in the Financial Stability Report.

([11]) Bank of Italy, Financial Stability Report.

([12]) Bank of Italy: The outstanding Targeted Longer-Term Refinancing Operations loans to the Banking System amounted to EUR 318 billion in March 2023.

([13]) ECB Data: Private debt is relatively low in Italy. Household debt amounted to 42.6% of GDP in Q3 2022, and NFC consolidated debt stood at 69% in Q3 2022. In 2022, cost of borrowing increased significantly for both households and NFC, moving from 1.7% to 3.8% for households and from 1.4% to 3.7% for non-financial corporations (yoy change).

([14]) ECB BSI Data: As a benchmark, bank exposure to the domestic government was higher in Italy than in other main euro areas economies. In Q4-2022, domestic exposure on total assets was 5.1% in Germany, 5.4% in France, and 11.6% in Spain. The domestic government bond holdings on total assets were 1.6% in Germany, 2.6% in France, and 8.4% in Spain.

assets slightly decreased to 19.5% in December 2022, from a peak of 22% in September 2021, ([15]) the amount of public-guaranteed loans reached 15.4% of GDP in December 2022 ([16]). This amount may increase even further in view of the new liquidity schemes for energy-intensive industries. In addition, the majority of loans with a public guarantee ([17]) are variable interest rate loans and are exposed to the increase in financing costs. Over 2022, the 10-year sovereign bond yield has increased by 350 basis points (bps), due to the normalisation of monetary policy. After an increase in the first half of 2022 ([18]) and some episodes of volatility linked to the electoral cycle, the spread to the German 10-year bond has stabilised at the current level of around 170-195 bps. The increase in interest rates negatively affects the market value of securities and banks' ability to raise funds using government bonds as collateral. ([19]) Also, financial institutions have accumulated unrealised losses on securities held at amortised cost, ([20]) which do not directly affect capitalisation. Bank of Italy estimates that the materialisation of unrealised losses would reduce the CET1 ratio by around 200 bps. This scenario is mitigated by the prudent capital buffers that banks have accumulated in recent years and remain very unlikely due to the abundant liquidity available to the banking system.

Assessment of MIP relevant policies

Public expenditure as a share of GDP is expected to remain above pre-pandemic levels, despite the end of temporary support measures introduced in recent years. Fiscal policy measures implemented to counteract the economic and social consequences of the COVID-19 crisis and the subsequent exceptional increase in energy prices have led to a notable increase in the expenditure ratio. However, although the economic rebound and the phasing-out of some emergency measures have reduced the public expenditure-to-GDP ratio already in 2022, it is expected to remain above pre-pandemic levels in the short term. This is due to permanent policy measures introduced in recent years, including a more generous single and universal allowance, and higher resources allocated to ministries, local public services and public investment. Going forward, enhancing the efficiency and quality of public spending is crucial to support the decline of the public debt ratio.

Policies of the Recovery and Resilience Plan have been implemented to help reduce the debt-to-GDP ratio in the medium and long term, and more are in progress or planned. Previous policies against tax evasion have contributed to significantly improve tax collection and

([15]) ECB BSI Data: Domestic exposure is calculated as the sum of the loans to the Government and the government securities held by the banking system. Between December 2021 and December 2022, the percentage of government securities on total asset decreased from 13% to 11.5%.

([16]) Documento Economia e Finanza 2023 and MEF data. This ratio does not include public guarantees deriving from international obligations. The majority of loans with a public guarantee have been granted under the scheme Garanzia Italia by SACE (EUR 42 billion in June 2022) and under the SME Guarantee Fund by Mediocredito Centrale (EUR 252 billion , in June 2022).

([17]) MEF data. Notably, 56% of loans guaranteed by the SMEs Guarantee Fund and 89% of loans guaranteed by SACE.

([18]) The spread between the Italian and the German 10y bonds reached a peak of 250bps in September 2022 and remained above 200bps during the election period.

([19]) Bank of Italy, Financial Stability Report. According to a Bank of Italy simulation for securities held at fair value, an upward shift of 100 basis points for the entire sovereign yield curve would lower the tier 1 ratio by 17 basis points on average (14 basis points for significant banks and 41 basis points for less significant banks). The amount of assets available for use as collateral for Eurosystem refinancing is likely to remain considerable even after an upward shift of 100 basis points in the entire sovereign yield curve: the value of the encumbered assets is expected to fall by EUR 27.4 billion (5.7 per cent of the total), while that of potentially eligible securities would fall by EUR 8.1 billion (4.0 per cent of the total).

([20]) Bonds placed into the amortised cost portfolio are not valued with market prices and therefore shielded from market volatility.

compliance. The RRP measures implemented in 2022, aimed at better targeting audits and controls together with the introduction of sanctions for businesses that refuse electronic payments, the collection of electronic payment data and the extension of compulsory electronic invoicing also to self-employed currently exempted, are expected to have further reduced tax evasion. On the expenditure side, Italy reinforced in the context of the RRP the spending review framework and provided for the launch of an annual spending review, incorporating its saving targets in the 2023 Budget. Some steps have been taken to define nation-wide reference standards for the provisions of certain services and for the related costs, that, once completed, could increase transparency and encourage more spending efficiency at the subnational level.

On the contrary, some policy measures introduced recently risk jeopardising the results achieved so far. The temporary early retirement schemes adopted in recent years and prolonged to 2023, although with stricter eligibility criteria, are projected to contribute to growing pension expenditure until 2026, before the provisions of the 2011 pension reform start to slow pension spending growth. In their current form, proposals for differentiated regional autonomy may weigh on the ability of the central government to steer national public finances and worsen regional disparities. The increase of the legal threshold for cash payments and a new set of measures aimed at alleviating pending tax debts risk having a negative impact on tax compliance. Italy's fiscal sustainability would benefit from a growth-friendly tax shift from labour to other sources that are less detrimental to growth. The draft enabling law presented to Parliament in March 2023 only partly addresses this need while entailing further risks for the equity of the taxation system. Finally, the risk of higher public spending in the next years is exacerbated by the large number of guarantees granted during the pandemic, which increased the government's contingent liabilities.

Already implemented and ongoing measures of the Recovery and Resilience Plan have the potential to spur competitiveness and productivity. The government is on track in the implementation of the enabling law to reform the judicial system adopted in 2021 to enhance its efficiency. Moreover, additional resources have been deployed to clear the backlog of cases before courts. The timeliness and greater predictability of legal decisions should make the Italian economy more attractive for domestic and foreign investment. Similarly, the measures on public procurement, including the reform adopted in 2021 and the 2023 revision of the code of public procurement are conducive to simpler and faster procedures for awarding public contracts and ultimately to the improvement of the business environment. The measures adopted in 2022 concerning the public administration, particularly on public employment and administrative capacity, have the potential to strengthen administrative capacity, especially at local level, and increase the efficiency and effectiveness of the administration. In 2022, the education system has been reformed at all levels. Particularly, the reform of the teaching profession has the potential to improve educational outcomes in the medium term. Finally, through the recently adopted 2022 annual competition law, the government removed barriers to competition and improved regulations in selected sectors, while already in 2021 it had implemented the Transizione 4.0 tax credit, as part of RRF-supported measures to favour the digitalisation of business.

Measures implemented in 2022, many of which included in the Recovery and Resilience Plan, are expected to increase skills and participation rates and to ease the transition of young people from education into the labour market. The National Programme for the Guaranteed Employability of Workers (GOL) and the National Plan for New Skills, adopted in 2021, have the potential to raise labour market participation and facilitate job transitions, while reducing hysteresis effects, regional disparities and skill mismatches. As of January 2023, according to the Italian authorities, more than 800 000 beneficiaries of the GOL programme received personalised assistance, more than half of whom receive services of job reintegration. ([21]) A three-year plan to

([21]) ANPAL note monitoring the implementation of the GOL programme: https://www.anpal.gov.it/documents/552016/1309678/Nota+GOL_Focus+ANPAL+148_31012023_rev15022023def.pdf/8bfb501d-3f6a-850d-46ea-730f36e90e95?t=1676635731635

strengthen Public Employment Services was also adopted in 2021. Ensuring an equal balance in the provision of employment services across regions will be essential to reduce territorial disparities. Adopted in 2022, the reforms to enhance the vocational training system and the technical and professional institutes are expected to support students' transition from education to the labour market and to bridge mismatches between supply and demand of young workers. However, lowering the entry barriers to the labour market more effectively, particularly for women, requires strengthening the provision of affordable quality early childhood education and care. The effective implementation of the RRP investments in childcare and long-term care is expected to support women's labour market participation in the medium term. Regarding the social safety net, the 2023 Budget tightened the conditions to access the minimum income scheme and abrogated it starting from 2024. It will be replaced by an "income top up" for the lowest-earning households to contrast poverty and support inclusion, providing limited support for a renewable 18-month-period. To enhance participation rate it will be crucial to ensure a strong link with active labour market policies and focus on labour market activation of both the recipients of the new income support and the other vulnerable subjects not eligible under the new measure.

The reform of the insolvency framework as part of the Recovery and Resilience Plan entered into force in July 2022, and the government has implemented further measures to support the resilience of the financial sector. As part of the insolvency framework the early warning procedure and the out-of-court settlement are now operational and are expected to facilitate an earlier restructuring of companies under distress, thus preventing the accumulation of non-performing loans (NPL). A revision of the state-supported NPL securitisation scheme *"Garanzia sulla Cartolarizzazione delle Sofferenze"*, which was not renewed after June 2022, is being considered. The government is also taking action to mitigate the impact of rising financing costs on vulnerable households. ([22]) In this respect, the 2023 Budget introduced the possibility for lower-income borrowers (with an annual income below EUR 35 000) to renegotiate at favourable conditions the rate of their mortgages from variable to fixed. In relation to liquidity schemes, the capital endowment of the guarantee fund for small and medium-sized enterprises and of *SACE Garanzia Italia* – Support Italia, seem prudent and has been reinforced by the 2023 Budget.

While the implementation of the Recovery and Resilience Plan remains the key policy priority as it includes comprehensive reforms and significant investments, Italy faces challenges that call for further policy action. The RRP is entering a crucial phase. With many reforms already adopted, the implementation efforts will increasingly focus on the operationalisation of the reforms and on the significant investments envisaged by the plan. As investments often involve subnational bodies and private operators, it will be crucial to ensure an effective governance and strong administrative capacity, at all levels, to avoid any delay. In addition, some challenges will require action beyond the measures included in the RRP. Ageing and the surge in inflation are expected to increase pension expenditure, and a full application of the 2011 reform remains essential to guarantee the long-term sustainability of the pension system and, hence, fiscal sustainability. The tax burden on labour remains high, which hinders economic efficiency and growth, and a comprehensive tax reform could reduce the high tax wedge. Simplifying Italy's complex fiscal framework would help to foster transparency, accountability and fairness. Demographic trends point to a decline in the working-age population and aggravate the "brain-drain", which could be mitigated by measures to attract and retain high-skilled workers, further integrate people with a migrant background, as well as support families and young people. In addition to the already diversified gas supply, which lowers impediments for investment and capital deepening, there is potential to further diversify energy imports, speed up the roll out of

([22]) The share of debt held by vulnerable households (households with disposable lower than the median and debt service ratio above 30%) may increase from 1.5% to 9% in 2023 due to the increase in interest rates and the erosive effect of inflation on households' disposable income. Bank of Italy, Financial Stability Report, 2022.

renewable energies including by supporting required skills, improve energy efficiency, and promote sustainable transport and sustainable soil management.

Conclusion

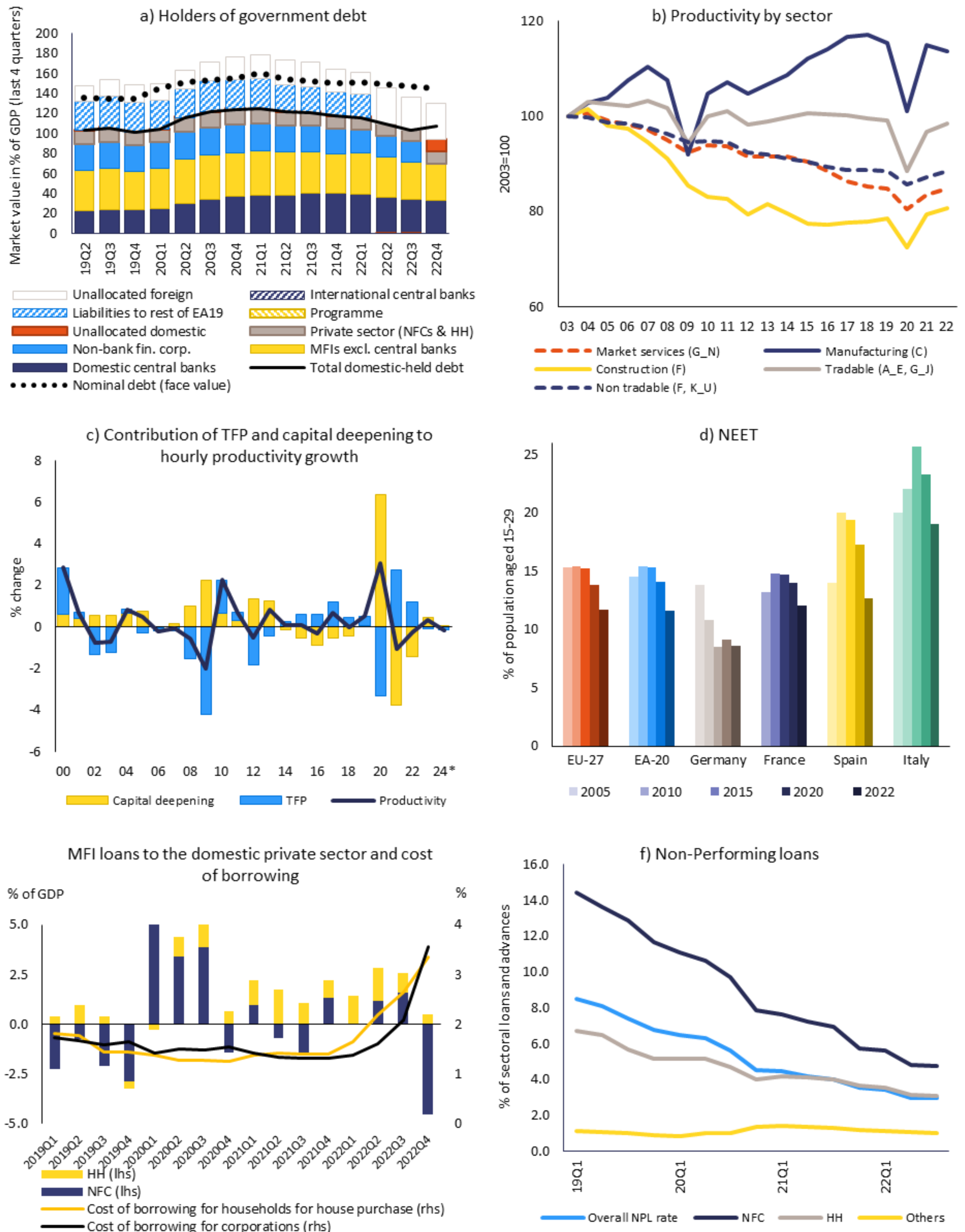
While there have been some improvements, Italy continues to face vulnerabilities with cross-border relevance, relating to the high government debt and weak productivity growth, in a context of labour market fragilities and some weaknesses in the financial sector. The pandemic crisis and its aftermath brought a sizeable increase in public debt. It started edging down in 2021 with the economic recovery and is set to decline further over the period to 2024. However, according to the 2023 Stability programme the public debt ratio would be expected to increase again in subsequent years in the absence of consolidation measures. Fiscal sustainability risks remain high over the medium term and medium over the long term. High volatility in productivity growth since the pandemic crisis has masked the underlying persistent structural shortcomings, and tightening financing conditions dampen the prospects for further capital deepening. Participation in the labour force is still low, especially among the young, women and residents in the South, although there have been visible improvements since pre-pandemic times. Labour market conditions improved markedly after the crisis, with the initial recovery in hours worked and temporary jobs gradually extending to permanent positions. Italian banks are still significantly exposed to the sovereign and to the performance of state-guaranteed loans in their balance sheets. Banks' 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 energy crisis and of financial tightening unfolds. A materialisation of risks stemming from these vulnerabilities could impact other EU Member States through various channels so that the vulnerabilities have cross-border relevance.

Some progress has been made with policies to tackle imbalances, though further sustained efforts are warranted. Putting the high public debt on a firm downward path, in a context of rising debt servicing costs due to the normalisation of monetary policy and rising age-related costs, requires a multipronged approach relying on prudent fiscal policies with adequate primary surpluses, growth-enhancing investments and reforms, greater tax compliance as well as an efficient use of national and European resources. Yearly spending reviews as of 2023 are expected to improve the efficiency and quality of public spending. The government kept up the efforts to adopt and implement reforms that are expected to spur competitiveness and productivity. These include measures to improve the business environment, to enhance the effectiveness of the public administration and the efficiency of the judicial system, and to improve educational outcomes, as well as investment, particularly in innovation, digitalisation and transport. In addition, structural adjustments related to the green transition and supply chain reorganisations open up an opportunity to improve efficiency. The effect of investments and reforms on the economy can take time to become visible and crucially depends on implementation. The effective implementation of the RRP thus remains essential, with measures to increase labour market participation, labour market transition of young people as well as workers reskilling and upskilling being expected to bring positive outcomes in the medium term. The progress made in the implementation of the insolvency reform is expected to support a more efficient allocation of financial resources. Italy is facing challenges that would benefit from additional policy efforts, notably in the areas of taxation, fiscal framework and pension systems as well as in the areas of demography, labour market, and energy.

Based on the findings in this in-depth review, the Communication "European Semester – 2023 Spring Package" sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Italy, in line with Regulation 1176/2011. ([23])

([23]) European Commission (2023), European Semester Spring Package 2022, COM(2023) 600 final.

Graph 2.1: **Selected graphs, Italy**



Source: European Commission services

Box 1: Inflation exposures and cross-border pass-through

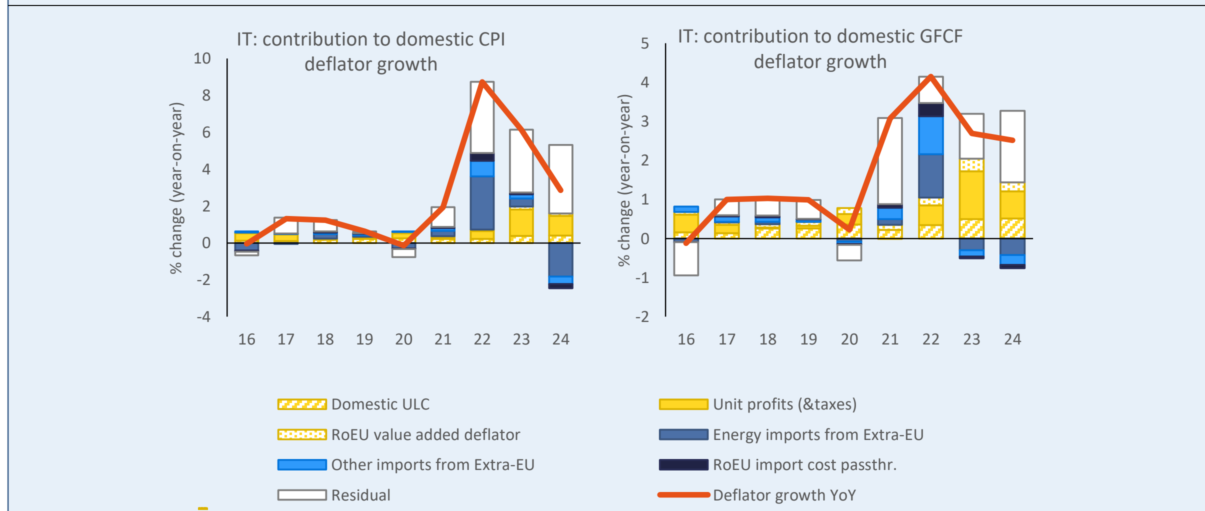
This box sheds light on the sources of inflation in Italy and its spill-overs with EU partners. The period since 2021 has been characterized by pandemic aftershocks and global supply chain disruptions compounding global inflationary pressures and a surge in commodity prices triggered by Russia's war of aggression against Ukraine. As a result, inflation in Italy surged. In response, wages and profits also picked up across the EU. With input-output data, domestic inflation can be decomposed into the contribution from key cost factors. Taking into account some data limitations, the framework can be used to attribute consumer and investment price changes to i) extra-EU import price changes, which include both directly imported inflation and inflation passed through from EU partners import costs ii) domestic unit labour cost changes iii) domestic unit profit changes, including indirect taxation changes and iv) rest-of-EU value added price changes. ([24])

Data suggests that much of inflation in Italy in 2022 reflected surging energy prices, while the importance of domestic factors is projected to increase. In 2022, as shown in Graph 2.2, energy imports were key drivers of both consumption and investment inflation. Extra-EU non-energy imports also contributed to the pick-up in inflation in Italy. Spill-overs from other EU countries remained muted. Namely, import cost pass-through from EU partners increased domestic inflation somewhat, whereas value added inflation in other EU countries had only a negligible impact. Unlike investment inflation, consumption inflation was not markedly affected by domestic factors, wages and profits. The impact of energy inflation is set to subside and to eventually dampen inflation. Similarly, the impulse from extra-EU non-energy import prices is expected to fade. However, the contribution from unit labour cost and, particularly, unit profits is expected to increase in both 2023 and 2024 compared to 2022. Spill-overs from inflation in other EU countries is set to remain marginal.

The impact of wage and profit growth in Italy on other Members States remains limited. Although Italy has a non-negligible impact on domestic demand in other Member States, spill-overs from value-added inflation are set to remain contained vis-à-vis the significant impact from import prices (see Graph 2.3). Overall, value added inflation in Italy has contributed little to consumer inflation in the rest of the EU so far. Luxembourg is the most exposed country in terms of value-added spillovers with the impact of around 0.2 pps. p.a. over the forecast horizon.

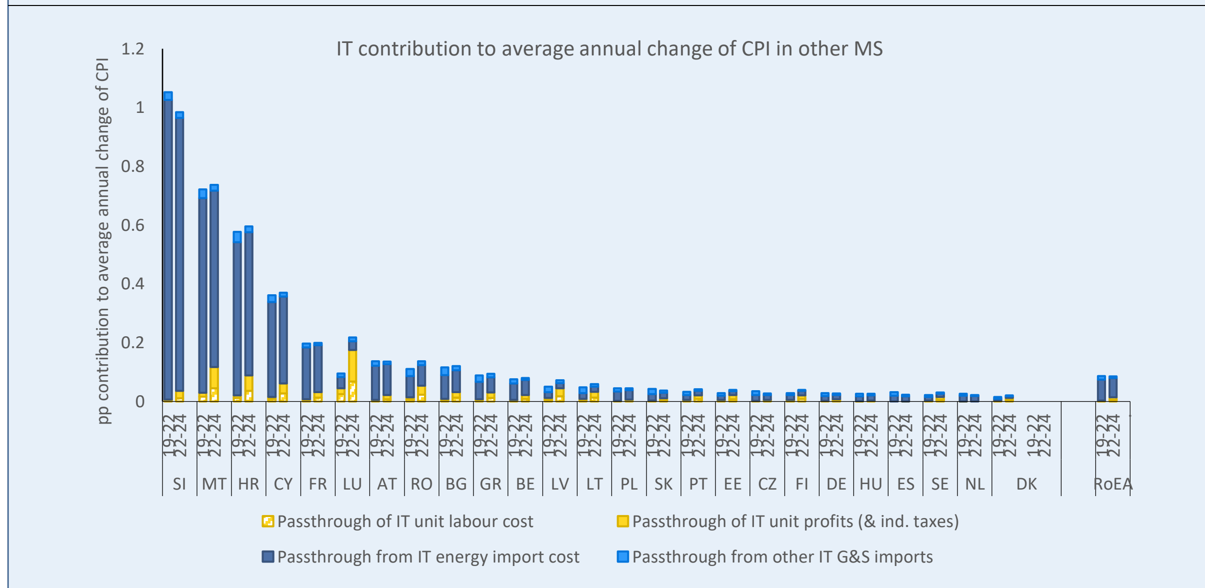
([24]) The graphs below are based on national accounts data and the Commission's Spring 2023 forecast, which are combined through a 'Ghosh' matrix based on Eurostat's Figaro input-output available for 2015-2020. HICP is taken as the measure of the price of private consumption, including non-residents. Energy import prices from extra-EU reflect realised median prices until 2022, and energy price assumptions underlying the Spring forecast thereafter. Other goods prices reflect median Eureopan prices per industry until 2022, and forecast non-energy goods and service trade prices for 2023-2024. Value added deflators are assumed to affect all industries within a country to the same degree. Changes in import prices and value added deflators are assumed to affect demand prices with a delay of 6 and 4 months for consumption and investment inflation, respectively. For a similar analysis using an input-output-based methodology, see "Inflation Differentials in Europe and Implications for Competitiveness: Thematic Note to Support In-Depth Reviews" European Commission 2023, Institutional paper 198.

Graph 2.2: **Components of gross fixed capital formation deflator growth and consumer price inflation**



Source: European Commission services

Graph 2.3: **Impact of Italian value added inflation on EU partners' consumer price inflation**



Source: European Commission services

Table 2.1:**Selected economic and financial indicators (Part 1), Italy**

								forecast	
all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	2023	2024
Real GDP	1.1	-1.4	0.5	0.5	-9.0	7.0	3.7	1.2	1.1
Potential growth (1)	0.8	-0.2	0.0	0.0	-0.1	0.1	0.9	0.8	0.9
Contribution to GDP growth:									
Domestic demand	1.0	-1.7	0.3	0.2	-7.6	6.4	4.6	0.7	0.8
Inventories	0.1	-0.2	0.2	-0.4	-0.5	0.4	-0.4	0.0	0.0
Net exports	0.0	0.6	-0.1	0.7	-0.8	0.2	-0.5	0.6	0.3
Contribution to potential GDP growth (1):									
Total Labour (hours)	0.3	-0.3	0.0	-0.4	-0.4	-0.5	0.3	0.1	0.1
Capital accumulation	0.6	0.3	-0.1	0.0	-0.1	0.2	0.4	0.4	0.4
Total factor productivity	-0.2	-0.1	0.0	0.4	0.4	0.3	0.3	0.3	0.4
Output gap (2)	1.9	-1.1	-2.6	0.6	-8.3	-2.0	0.7	1.1	1.3
Unemployment rate	7.6	8.5	11.8	9.9	9.3	9.5	8.1	7.8	7.7
Harmonised index of consumer prices (HICP)	2.3	2.4	0.7	0.6	-0.1	1.9	8.7	6.1	2.9
GDP deflator	2.5	1.5	1.4	0.9	1.6	0.6	3.0	5.9	2.7
External position									
Current account balance (% of GDP), balance of payments	-1.0	-2.2	2.1	3.3	3.9	3.1	-1.3	0.0	1.3
Trade balance (% of GDP), balance of payments	-0.1	-0.7	2.8	3.4	3.6	2.3	-1.5	.	.
Primary income balance (% of GDP)	0.1	-0.3	0.2	0.8	1.2	1.9	1.2	.	.
Secondary income balance (% of GDP)	-1.0	-1.2	-0.9	-0.9	-1.0	-1.1	-0.9	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-0.4	0.0	0.8	1.4	1.5	1.3	1.5	1.5	1.4
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-0.3	-0.2	-0.4	0.1	0.2	0.5	0.4	0.5	0.5
Capital account balance (% of GDP)	0.1	0.1	0.1	-0.1	0.1	0.1	0.5	.	.
Net international investment position (% of GDP)	-16.7	-21.0	-14.8	-1.5	1.5	8.3	3.9	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-9.4	-22.4	-14.4	-0.5	1.0	6.2	1.7	.	.
Net FDI flows (% of GDP)	0.4	1.0	-0.1	0.1	1.1	1.7	-1.1	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	2.7	2.1	1.1	1.3	3.1	-0.4	2.8	3.1	3.1
Nominal compensation per employee	2.7	1.1	0.8	1.3	-4.1	5.9	4.8	3.9	4.1
Labour productivity (real, hours worked)	0.1	0.0	0.2	0.5	3.1	-1.0	-0.3	0.2	0.7
Real effective exchange rate (ULC)	1.4	0.3	-0.6	-0.8	-2.2	0.3	-0.8	-2.7	-0.5
Real effective exchange rate (HICP)	1.6	-0.4	0.5	-2.1	0.3	-0.2	-1.4	.	.
Export performance vs. advanced countries (% change over 5 years)	-1.7	-12.4	-6.9	-4.0	-2.3	-1.6	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	97.0	121.3	114.5	106.0	118.4	113.5	107.1	.	.
Household debt, consolidated (% of GDP)	32.8	42.4	41.7	41.1	44.9	43.3	42.0	.	.
Household debt, fundamental benchmark (% of GDP) (6)	10.3	11.2	15.7	20.9	23.8	25.1	26.3	.	.
Household debt, prudential threshold (% of GDP) (6)	35.0	35.0	35.5	34.4	35.3	35.5	36.2	.	.
Non-financial corporate debt, consolidated (% of GDP)	64.2	78.9	72.8	64.9	73.5	70.2	65.1	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	27.3	24.1	23.8	25.8	27.7	28.6	28.8	.	.
Corporate debt, prudential threshold (% of GDP) (6)	59.5	58.2	58.0	56.2	59.2	59.8	61.3	.	.
Private credit flow, consolidated (% of GDP)	9.3	2.9	-0.2	0.4	4.0	3.5	2.6e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.1	0.6	2.9	3.4	6.2	6.2	5.1	5.4	5.5
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	0.9	1.8	1.4	7.4	6.0	2.1	-0.9	-0.6
Net savings rate of households (% of net disposable income)	8.7	4.6	3.0	2.4	10.2	7.6	2.1	.	.

(1) (e) estimate based on ECB quarterly data
(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.
(2) Deviation of actual output from potential output as % of potential GDP.
(3) 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.
(4) This benchmark is defined as the average current account required to halve the gap between the NIIP and the indicative MIP benchmark of -35% of GDP over the next ten years, or to stabilise the NIIP at the current level if it is already above the indicative MIP benchmark. Calculations make use of Commission's T+10 projections.
(5) 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.
(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on 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 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

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

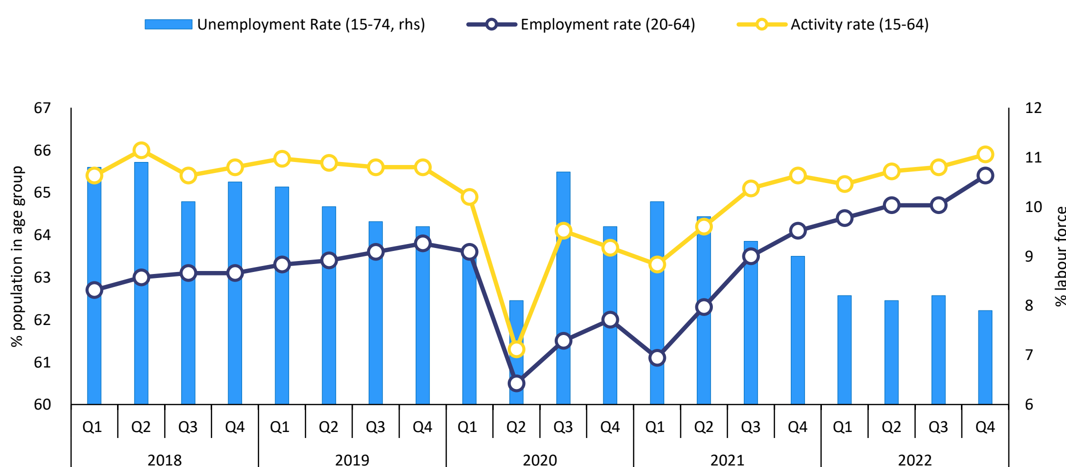
all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-18	2019	2020	2021	2022	forecast 2023	forecast 2024
Housing market									
House price index, nominal	6.1	0.3	-2.8	-0.1	1.9	2.6	3.8	.	.
House price index, deflated	3.6	-1.6	-3.4	-0.7	1.8	1.0	-3.4	.	.
Overvaluation gap (%) (7)	9.4	17.1	-3.7	-9.6	-7.8	-7.7	-9.4	.	.
Price-to-income overvaluation gap (%) (8)	6.0	16.7	-0.6	-9.1	-5.7	-6.9	-9.3	.	.
Residential investment (% of GDP)	5.4	5.4	4.2	4.0	4.0	5.3	5.8	.	.
Government debt									
General government balance (% of GDP)	-3.1	-3.7	-2.6	-1.5	-9.7	-9.0	-8.0	-4.5	-3.7
General government gross debt (% of GDP)	105.6	117.6	134.4	134.1	154.9	149.9	144.4	140.4	140.3
Banking sector									
Return on equity (%)	9.7	-0.6	-1.5	4.8	0.8	5.4	.	.	.
Common Equity Tier 1 ratio	6.9	8.8	12.5	15.1	17.2	16.9	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (9)	4.4	8.3	11.5	5.4	3.5	2.7	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	13.5	6.7	4.5	3.5	3.0	.	.
Cost of borrowing for corporations (%)	4.8	4.0	2.5	1.7	1.6	1.3	3.6	.	.
Cost of borrowing for households for house purchase (%)	4.3	3.8	2.4	1.4	1.3	1.4	3.3	.	.

(7) 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 to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) 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 2023-04-28, where available; European Commission for forecast figures (Spring forecast 2023)

3. THEMATIC CHAPTER: LABOUR MARKET

Labour supply weaknesses continue to weigh on potential output, but wage moderation keeps Italy competitive. Overall, the labour market situation improved significantly in 2022, with the usual lag compared to the post-pandemic output recovery that started in 2021. The unemployment rate continued its steady decline from the peak of 12.9% in 2014, reaching 8.1% in 2022 on average. The activity rate rose to 65.5%, still slightly below the 2019 level and 9 percentage points lower than the euro-area average (graph 3.1). In addition, large mismatches between local demand and supply persist, largely due to an insufficient provision of suitably qualified workers in the areas where they are required. Given such persistent labour slack, wage growth has been widely outpaced by consumer price inflation, on the one hand hurting real disposable income, but on the other hand allowing to keep Italy's goods and services competitive vis-à-vis trade partners.

Graph 3.1: **Employment rate, activity rate and unemployment**



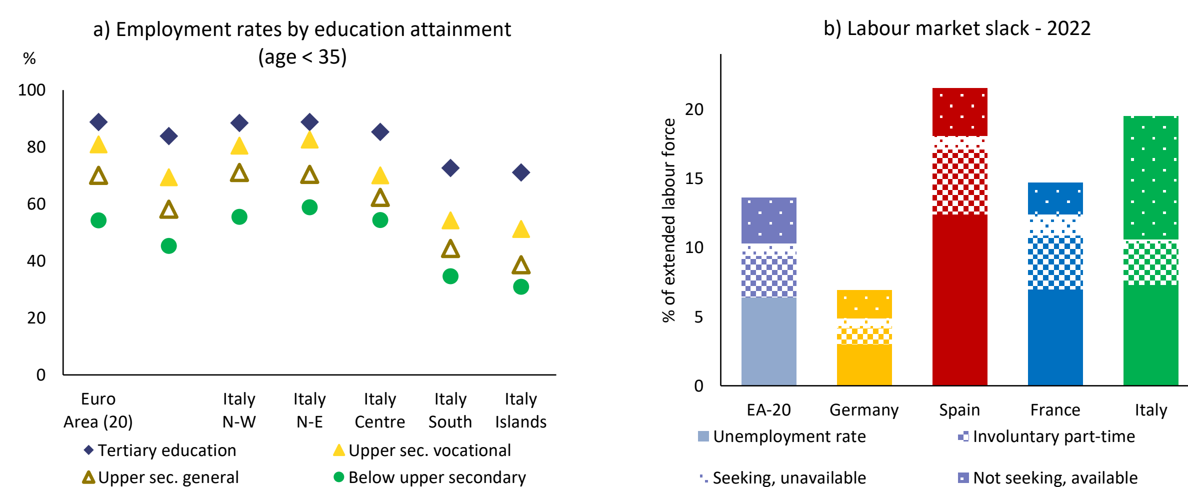
Source: European Commission services

In 2022, the structural challenges of the Italian labour market in terms of gender, age and territorial disparities have only slightly diminished. The unemployment rate in 2022 remained considerably higher among women (9.4%) than men (7.1%). Despite an overall robust post-pandemic increase, women's employment rates, at 55% of the population aged 20-64, are around 20 percentage points below those of men and over 14 points below the euro-area female employment rate (69.1%). Wide gender gaps also exist in the employment rate of people with migrant background (particularly from non-EU countries). As for regional imbalances, in the third quarter of 2022 the unemployment rate in the South (14%) was more than double that in the Centre (6.6%) or North (4.9%). Female labour market participation is also much lower in the South, where little more than one-third of women are in the workforce, compared to nearly two-thirds in the North (for Southern men, the employment rate is just above 60% while it approaches 80% in the North). These geographic disparities have diminished only slightly between 2019 and 2021.

Youth employment rates remain low, particularly in Southern regions. Overall, just 61.9% of Italians aged 15-34 are employed, compared to 76.4% in the euro area. After the steep fall in the first half of the last decade, this represents a slow improvement, even though the gap with the euro area has increased over the last two years, with Northern regions faring much better. In

addition, the unemployment rate of young people (15-24) is almost three times higher than the one of the total population, with more than one out of five persons aged between 15 and 24 unemployed, and the unemployment rate in this age group in the South is twice that in the North (graph 3.2 a). When looking at educational attainment, those having achieved tertiary degrees (academic or vocational) have as many chances of finding employment in Italy's North as on average in the euro area; this holds true also for young graduates of upper secondary education, particularly vocational. In Italy's South, conversely, employment rates are much lower across the whole range of education attainments; this range is however slightly broader, implying relatively higher employment rewards for those achieving tertiary degrees. The share of young people (15-29) who are not in employment, education or training (NEET) dropped to 19% in 2022, down 4 percentage points from the previous year; yet, it remains 7½ points above the euro-area average, and is significantly higher for young people with migrant background.

Graph 3.2: **Employment rates and labour market slack**



Source: European Commission services

A considerable temporary drop in the participation rate related to the COVID-19 pandemic was not accompanied by a comparable increment in the unemployment rate. The pandemic shock negatively affected labour market participation: the activity rate (15-64) hit a 61.3% low in Q2-2020, during the first lockdown wave, and did not recover to its pre-pandemic level until mid-2022. By contrast, unemployment dynamics reacted more moderately to the Covid-19 crisis and the unemployment rate was below the 2019 pre-pandemic level already during the first half of 2021. The moratorium on job terminations put in place by the Italian government, the extended use of existing wage-supplementation schemes and the adoption of new short-time working schemes to protect employment, also benefitting from support through SURE, limited the impact of the pandemic on job losses.

The marginal reduction in employment was mirrored by a higher reduction in hours worked, in particular in the service sector. As a result of the measures put in place by the Italian government during the initial pandemic months, the employment rate decreased moderately while the drop in hours worked was stronger. The considerable decrease in hours worked observed in Q2-2020 was mostly driven by a reduction in services, particularly contact-intensive ones such as trade, tourism, and entertainment. These are sectors where women and young people are the predominant part of the workforce and that are particularly relevant for the local economy in the South.

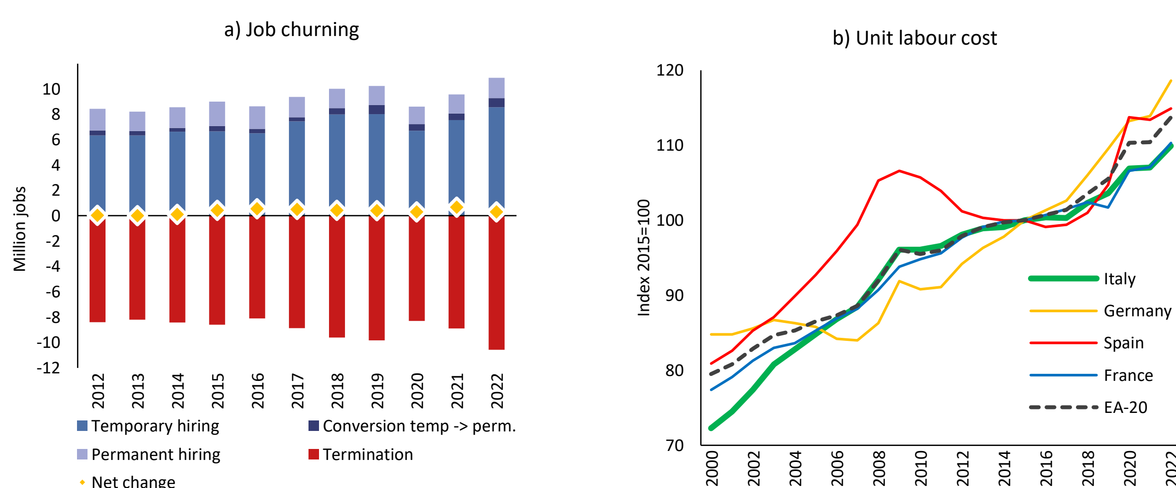
In the last three years the Italian labour market presented substantial slack, in some cases higher than that observed for other European peers. While the unemployment rate is

an important indicator of labour market vigour, it can be complemented by additional indicators, including: (i) underemployment, i.e. the number of persons involuntarily working part-time; (ii) the number of persons seeking work but not immediately available; and (iii) the number of persons available to work but not seeking it. Together with the unemployment rate itself, these metrics are combined in the 'Labour market slack' indicator, measured as a share of the extended labour force, which includes groups (ii) and (iii) on top of the employed and unemployed. This indicator dropped just below 20% in 2022, from above 22% in 2018-2021. However, Italy – together with Spain – displayed substantially more labour slack than France or Germany, particularly in the younger age cohorts (graph 3.2 b). This is essentially due to Italy's larger number of persons available to work but not seeking (9%) than in the three other countries (2.1 to 3.4%). Finally, undeclared work still represents a sizeable share of the total, adding to the officially measured slack and disproportionately affecting vulnerable groups such as people with a migrant background.

The incidence of involuntary part-time work in Italy is high, in particular among men and young people. A large proportion of the workers performing part-time work would prefer full-time jobs; although the youngest cohort has the largest share of involuntary part-timers, for older workers the share has grown even more in the last decade (graph 3.5 b). The share of involuntary part-timers is higher among men than women, even though part-time in general remains more frequent among women due to caring responsibilities.

Job creation and destruction have returned to the pre-pandemic dynamics, with an increase in the number of permanent contracts signed. The total number of job contracts activated and terminated in 2022 was higher than in 2019, highlighting a return to the pre-pandemic level of labour market dynamism. In 2022, while the largest share of newly signed contracts was temporary, an increasing number of new permanent contracts were created or converted from temporary ones (graph 3.3 a). This trend continued in early 2023, reaching pre-pandemic conversion rates (around 3% of total). A strong recovery in the recruitment of women occurred over 2021-22, compensating their relatively higher job loss during the pandemic. The largest number of fixed-term contracts are signed in the services and agriculture sectors, including for seasonal work and for very short-time (often daily) jobs in the media, arts and entertainment field. Apprenticeship contract openings have also returned to their pre-crisis annual volume of 0.4 million, around half of which are eventually converted into permanent positions.

Graph 3.3: **Job churning and ULC**



Source: European Commission services

Firms' vacancy rates continue to increase. From a low of 0.6% at the depth of the COVID-19 crisis, the total vacancy rate in firms with employees reached an average of 2.2% in 2022. The construction sector had relatively more open vacancies (3.3%) than market services (2.2%) or

manufacturing (1.9%). This is likely related to the public interventions (such as the Superbonus) directed towards the construction sector. Within the services sector, food and accommodation services (3.8%), and ICT services (2.9%) also posted high vacancy rates. Despite the recent increase, in 2022 Italy's total vacancy rate remained well below the euro-area average (3.1%) and Germany (4.3%).

Firms find it ever more difficult to find suitable workers. According to the latest employer survey, ([25]) in 2022 the total number of jobs deemed difficult to fill rose to 2.1 million, compared with 1.2 in 2019, bringing the share of difficult hires to 40% of total hires. The increase was particularly strong for technical, but not necessarily high-educated occupations, and for jobs in the trade and other services that were most affected by the pandemic. Unskilled jobs in trade, food and accommodation and other personal services actually recorded the largest increase, albeit from a low base. In absolute terms, however, the higher-skilled jobs requiring tertiary or specialised education remain in greatest – often unsatisfied – demand. A geographic mismatch between jobs and workers also plays a role, with work conditions attached to the jobs offered in the North not sufficient to attract suitably skilled workers from the South, taking into account differences in living costs.

The supply of skills remains insufficient, despite recent measures aimed at expanding vocational training. The share of 30-34-year-old people with tertiary education has decreased by one percentage point in 2021, to 26.8%, undoing part of the progress made until 2018 and lying more than 15 points below the euro-area average. The share of ICT graduates, at 1.4% in 2021, also stood well below the 3.9% EU average. However, considerable efforts, supported by the Italian RRP, are ongoing to expand the offer of vocational education and training (VET) where students can acquire the digital and green skills projected to be in highest future demand. The 2022 reform of tertiary vocational training provides for a new governance model at national level for employers' involvement in the organisation and implementation of dual VET programmes, a model currently limited to some geographic areas and sectors. While this can contribute to address the mismatch in the long term, other shorter-term actions appear necessary to simultaneously tackle firms' recruitment difficulties and entrenched unemployment in the Southern regions and among young people. Adult participation to VET programmes remains low but is expected to increase thanks to the additional resources put in place to support adult learning and the dual system in the RRP.

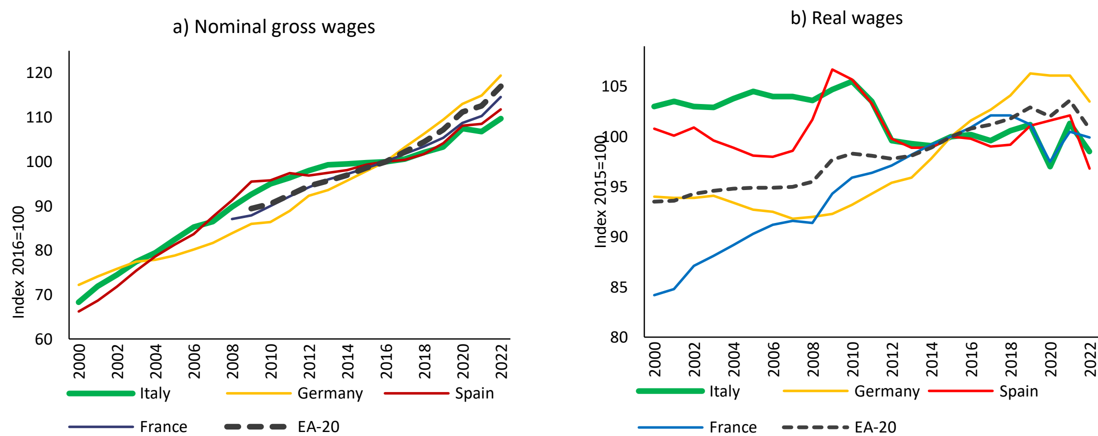
Wage moderation persists in the inflationary environment, preserving price competitiveness. The Italian wage bargaining system, centred on multiannual (typically 3-year) national contracts per industry and anchored to a lagged measure of past inflation, contributes to the moderation. This is compounded by the long delay – over 2 years on average – with which contracts are renewed. ([26]) In fact, nominal hourly contract wages only rose by around 6% cumulatively between 2015 and 2022 but are thus expected to rise somewhat faster in 2023-24. In subsequent years, unless more working-age migrants are admitted in Italy, the much higher projected number of workers reaching pension age than that of new entrants will increase labour market tightness and could hence push up wages. A second tier of bargaining can complement national contracts at the firm level, with wage bonuses linked to productivity growth or other outcome indicators. However, such second-level bargaining only covers 15% of employees, almost entirely excluding those working in small-sized firms, Southern regions, and specific industries (tourism, construction). The relatively narrow diffusion of firm-level wage incentives hinders the reallocation of workers to jobs where they could be more productive, within each industry covered by the same national contract. After the COVID-19 peak due to the sharp drop in hours worked,

([25]) Sistema informativo Excelsior, managed by Unioncamere (Federation of chambers of commerce) and ANPAL (national agency for active labour market policies), with financial support from the European Social Fund.

([26]) At the end of 2022, nearly 50% of employees had a contract expired (35% in the private sector and 100% in the public sector); the average waiting time before renewal is 24.8 months. Contract renewals usually provide for the retrospective payment of arrears.

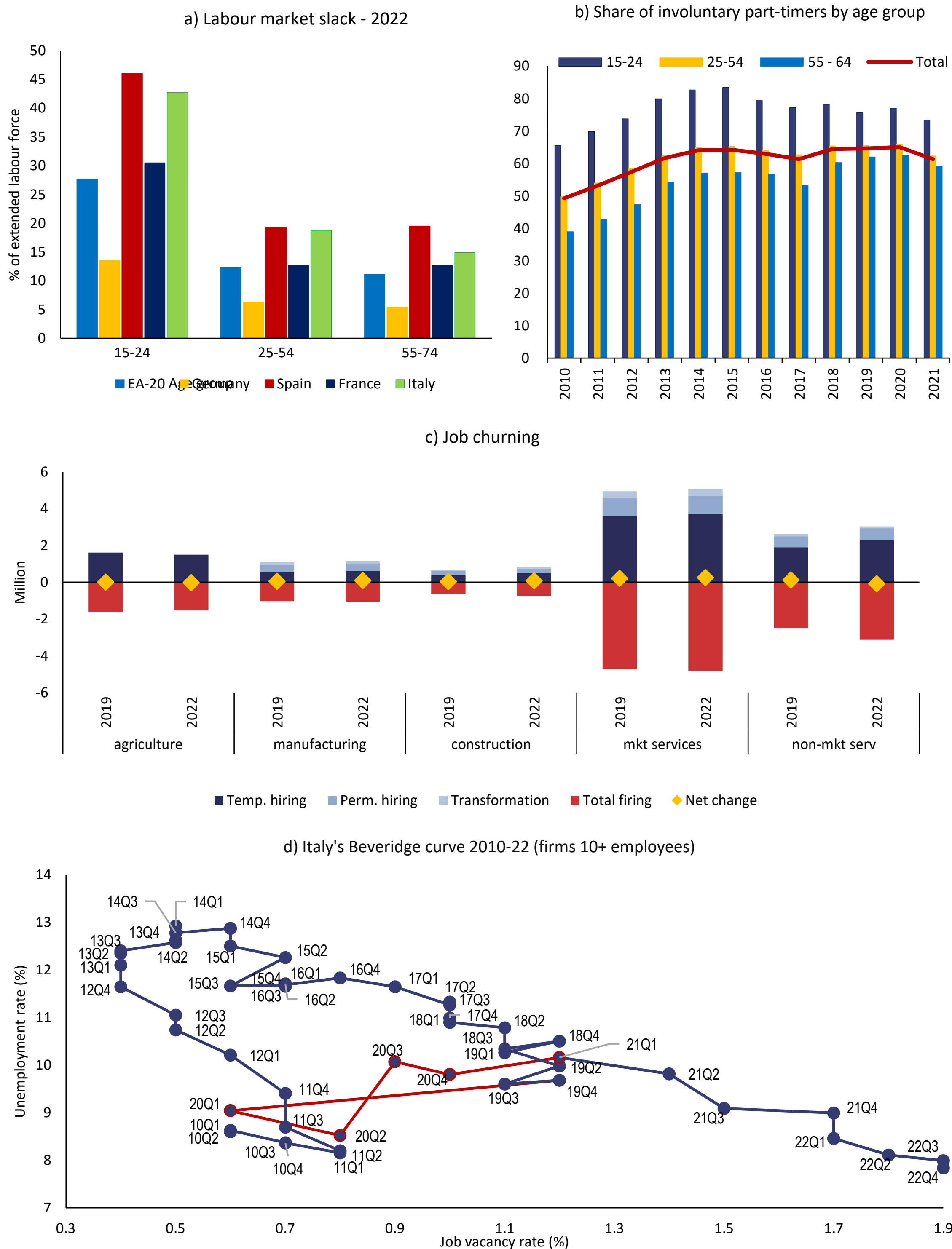
wages have recovered more rapidly in the export-oriented manufacturing sector, despite the above-mentioned fewer relative vacancies. Upcoming contract renewals in key service industries, such as trade, accommodation and public administrations, may however reverse the trend. Over 2012-2022, real wages decreased by 1.1% in Italy while they grew in France (2.8%), Germany (8.1%) and in the euro area as a whole (3.0%). The long-term growth of real wages in Italy has been even weaker than that of labour productivity. Consequently, the share of Italian labour income in total income has remained well below the euro-area average, while nominal unit labour costs have grown broadly in line with France but below Germany and Spain (graph 3.4). At the aggregate economic level, wage moderation supported Italy's external competitiveness, as reflected in only slightly growing unit labour costs and falling real effective exchange rates.

Graph 3.4: **Nominal and real wages**



Source: European Commission services

Graph 3.5: **Annex on labour market**



Source: Istat, quarterly survey on vacancies and hours worked (in red the Covid-19 period)