12. ITALY

Italian economy and public finances at a crossroads

After solid growth in 2017, Italy's economy slowed down over the first half of this year as exports and industrial production weakened. A recovery in exports and higher public spending are expected to support growth moderately over the forecast period. However, the associated rise in the government deficit, coupled with higher interest rates and substantial downside risks, endangers the reduction of Italy's high debt-to-GDP ratio. Inflation is set to accelerate slightly in line with higher energy prices.

Italy's economy is going through a soft patch

After reaching 1.6% in 2017, real output expansion decelerated on the back of a weakening manufacturing sector and flagging exports in the first half of 2018. Economic activity stalled in the third quarter, partly due to the slowdown in the automotive sector, and is expected to remain muted in the very near term. Real GDP growth in 2018 is forecast at 1.1%. Investment is likely to be the main growth driver supported by tax incentives and on average still favourable financing conditions despite financial market turbulences.

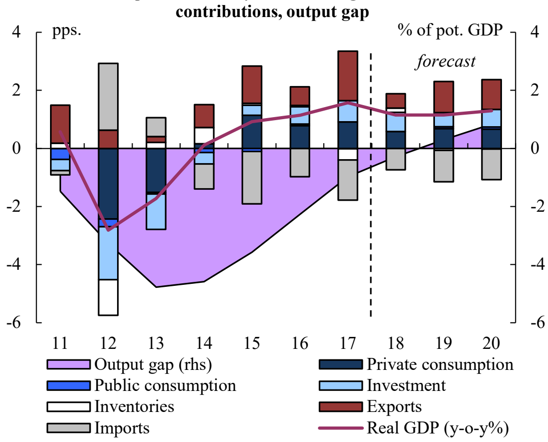
External and internal demand support growth

In 2019, a recovery of exports and higher public spending will help lift real GDP to 1.2%, while the output gap is expected to close. However, implementation lags and administrative bottlenecks are expected to delay the moderate growth impact of policy measures over the forecast period. The recovery of private investment is forecast to slow down as tailwinds such as accommodative monetary policy and tax incentives wane and firms face tighter financing conditions, linked to the impact of higher sovereign spreads on the supply of credit. Private consumption is set to continue growing at steady albeit moderate rates thanks to moderately growing wages and employment as well as increases in social transfers. However, higher oil prices will likely weigh on consumer spending.

In 2020, which has two additional working days, real GDP growth is forecast at 1.3%, supported by investment, especially in construction. Exports are set to grow broadly in line with export markets, while Italian exporters are set to keep their competitive position, thus containing market share losses incurred in 2018.

The growth outlook is subject to high uncertainty amid intensified downside risks. A prolonged rise in sovereign yields would worsen banks' funding conditions and further reduce credit supply, while public spending could crowd out private investment. Envisaged policy measures might prove less effective, having a lower impact on growth. Uncertainty about government policies might affect sentiment and domestic demand. Finally, the planned rollback of structural reforms bodes ill for employment and potential growth.

Graph II.12.1: **Italy - Real GDP growth and contributions, output gap**



Labour market is improving only slowly

Employment is expected to grow by about 1% annually in 2018-2020, in line with economic activity and supported by hiring incentives. The unemployment rate is set to fall to 10% by 2020. Wage growth accelerated in 2018 on the back of pay rises in the public sector. However, the slack in the labour market implies that wage pressures and the increase in unit labour costs are likely to remain moderate over the forecast period.

Consumer prices are set to rise moderately

The headline HICP index is expected to increase by 1.3% this year and by 1.5% in 2019, largely driven by higher oil prices. Headline inflation should moderate to 1.4% in 2020, while core inflation is forecast to rise gradually to 1.4%. The GDP deflator is set to increase by 1.3% this year, partly due to higher public sector wages, and to grow broadly at this rate over the forecast period.

Government deficit expected to increase

After stabilising at 2.4% of GDP in 2017 due to extraordinary costs to support the banking sector, the government deficit is set to decline to 1.9% of GDP in 2018. Public wages were slightly raised, and the reduction of corporate tax rates introduced in 2017 had a delayed negative impact on revenues. Social security contributions benefitted from the end of the temporary reduction for newly hired employees. The structural balance is projected to remain around -1¾% of GDP.

In 2019, the government deficit is expected to increase to 2.9% of GDP due to the planned measures. Public spending will significantly increase following the introduction of a minimum income scheme, higher flexibility for early retirement and increased funds for public investment. Partial financing is provided by a spending review and several changes in the tax regime, especially for firms, which will temporarily support revenues. The previously budgeted simplified tax regime for small firms (IRI) and the tax incentives for firms' capital uplifts (ACE) will be replaced by the extension of a simplified tax regime for the self-employed and a reduction of corporate tax rates for firms increasing investment or hiring. The structural balance is expected to deteriorate to -3% of GDP.

In 2020, the government deficit is projected to reach 3.1% of GDP. This forecast does not consider the increase in VAT rates legislated as a safeguard clause, given past systematic repeals. The delayed impact of the tax cuts planned for 2019 and higher funds for public investment are expected to be only partially offset by strengthened provisions for electronic invoicing and temporary revenues from a new tax amnesty. The structural balance is projected to further deteriorate to -3½% of GDP.

Risks to the deficit projections include higher risk premia on sovereign yields, lower-than-expected savings from the spending review and higher spending due to the possible renewal of public wage contracts. Conversely, the possible activation of the safeguard clause in 2020 and potential underspending related to the new measures represent upward risks to the fiscal projections.

Due to the fiscal deterioration, coupled with downside risks to nominal growth, Italy's large debt-to-GDP ratio is forecast to remain stable at around 131% over the forecast period.

Table II.12.1:

Main features of country forecast - ITALY

		2017		Annual percentage change						
	bn EUR	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		1725.0	100.0	0.3	0.9	1.1	1.6	**1.1**	**1.2**	**1.3**
Private Consumption		1048.9	60.8	0.2	1.9	1.3	1.5	**1.0**	**1.1**	**1.1**
Public Consumption		320.0	18.5	0.7	-0.6	0.3	-0.1	**0.0**	**0.3**	**0.4**
Gross fixed capital formation		303.9	17.6	-0.6	2.1	3.5	4.3	**3.7**	**2.0**	**3.1**
of which: equipment		114.5	6.6	-0.5	4.6	6.6	8.8	**9.7**	**2.6**	**2.0**
Exports (goods and services)		537.9	31.2	1.9	4.4	2.1	5.7	**1.6**	**3.4**	**3.2**
Imports (goods and services)		486.0	28.2	1.6	6.8	3.6	5.2	**2.6**	**3.7**	**3.5**
GNI (GDP deflator)		1734.7	100.6	0.3	0.4	1.9	1.9	**1.3**	**1.2**	**1.3**
Contribution to GDP growth:	Domestic demand			0.2	1.4	1.4	1.6	**1.2**	**1.1**	**1.3**
	Inventories			0.0	0.1	0.0	-0.4	**0.1**	**0.1**	**0.0**
	Net exports			0.1	-0.5	-0.3	0.3	**-0.2**	**0.0**	**0.0**
Employment				0.1	0.7	1.3	0.9	**1.0**	**1.0**	**0.9**
Unemployment rate (a)				8.9	11.9	11.7	11.2	**10.7**	**10.4**	**10.0**
Compensation of employees / f.t.e.				2.4	1.0	0.3	0.2	**1.8**	**0.9**	**1.0**
Unit labour costs whole economy				2.2	0.7	0.4	-0.4	**1.6**	**0.8**	**0.6**
Real unit labour cost				0.2	-0.2	-0.7	-0.9	**0.4**	**-0.5**	**-0.8**
Saving rate of households (b)				13.1	10.6	10.5	9.6	**9.7**	**10.0**	**9.9**
GDP deflator				2.0	0.9	1.1	0.5	**1.3**	**1.3**	**1.4**
Harmonised index of consumer prices				2.1	0.1	-0.1	1.3	**1.3**	**1.5**	**1.4**
Terms of trade goods				-0.5	4.2	3.6	-2.2	**-0.7**	**-0.1**	**0.2**
Trade balance (goods) (c)				0.6	3.1	3.4	3.2	**2.8**	**2.7**	**2.8**
Current-account balance (c)				-0.8	1.4	2.5	2.7	**2.6**	**2.5**	**2.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.7	1.7	2.3	2.7	**2.5**	**2.4**	**2.4**
General government balance (c)				-3.2	-2.6	-2.5	-2.4	**-1.9**	**-2.9**	**-3.1**
Cyclically-adjusted budget balance (d)				-3.0	-0.7	-1.3	-1.9	**-1.8**	**-3.0**	**-3.5**
Structural budget balance (d)				-3.6	-0.5	-1.5	-1.8	**-1.8**	**-3.0**	**-3.5**
General government gross debt (c)				109.8	131.6	131.4	131.2	**131.1**	**131.0**	**131.1**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.