12. ITALY

Economic recovery to continue at a modest pace

Italy's economic recovery is set to continue at a modest pace, as still tight financing conditions and uncertainty hold back a stronger recovery. The phasing out of incentives for new hires is expected to lead to a deceleration in employment growth. The rise in energy prices sustains headline inflation while wage pressures remain muted. Deficit and debt are both set to broadly stabilise as a ratio of GDP.

Growth to continue at a modest pace

In the first half of 2016, Italy's economy continued to expand on a yearly basis. However, economic growth in the second quarter was dragged down by manufacturing. Real GDP is projected to grow by 0.7% in 2016 (after expanding at the same rate in 2015) as recent indicators point to a moderate growth in the second half of the year.

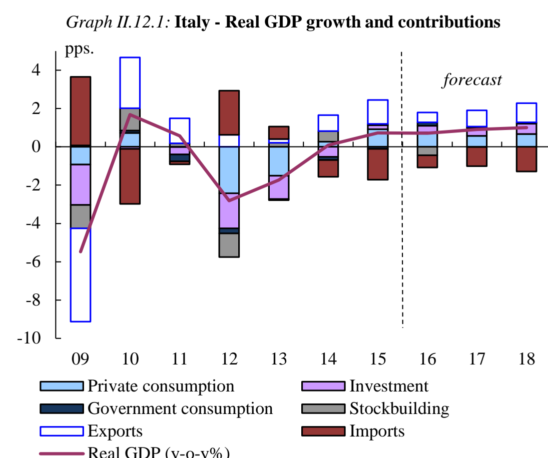
In 2017, real GDP is expected to increase by 0.9%, driven by both domestic demand and stronger exports as external demand recovers. Higher employment continues to support real disposable income and thus private consumption. A reduction in corporate tax and new public incentives are designed to support a recovery in investment in equipment and innovation. Larger and healthy firms can self-finance their investment and take advantage of improving market funding, benefitting from the broadening of the ECB asset purchase programme. Bank lending is set to increase only very gradually, since non-performing loans still burden bank balance sheets and hinder their profitability. These developments are expected to continue weighing on small firms' financing conditions. The recovery in construction is forecast to be gradual for the same reasons. Overall, the moderate growth of investment expected over the forecast horizon is set halt the ongoing depletion of the capital stock.

Italy's economic recovery is forecast to continue in 2018, sustained by domestic and external demand. The current-account surplus is projected to decline from 2.8% of GDP in 2016 to 2.1% in 2018 with the expected increase in savings more than offset by higher investment. Downside risks stem from policy uncertainty, especially due to the 4 December referendum on constitutional reform, a further slowdown in external demand, and the slow adjustment of the banking sector.

Employment growth to slow down

The three-year social contribution cuts for new permanent hires granted in 2015 and 2016 have been supporting the increase in headcount employment seen since 2015. However, as incentives expire at the end of 2016, employment growth is projected to subside in 2017 and 2018. Moreover, employment growth is expected less in terms of headcount and more in working hours. As a result, the unemployment rate is set to decline only marginally over the forecast horizon, also because previously discouraged people are expected to join the labour force. Upward pressure on labour costs is projected to remain limited, also thanks to cuts to the labour tax wedge. Moreover, the increases in real wages realised over recent years is deemed to be taken into account in future bargaining rounds. Overall nominal unit labour costs are projected to slightly increase, with a temporary uptick in 2018 due to a base effect of expiring incentives on new hires.

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



Energy prices to push up inflation

In 2016, consumer prices are forecast to remain stable as the fall in imported energy prices is offset by a moderate increase in core inflation (0.6%). HICP inflation is expected to rise to 1.2% in 2017 and to 1.4% in 2018, mainly driven by the recovery in energy prices. Core inflation is set to stay low and only gradually recover (0.8% in 2017 and 1.1% in 2018) as wage pressures are expected to remain very limited and profit margins recover gradually after being squeezed during the crisis.

Deficit- and debt-to GDP ratios to broadly stabilise

In 2016, the general government deficit is forecast to decline slightly to 2.4% of GDP (from 2.6% in 2015) thanks to a higher primary surplus and lower interest expenditure. Current primary expenditure is set to increase by less than 2% in nominal terms. Public investment is anticipated to remain broadly stable, while other capital spending is projected to decline significantly, mainly as a result of sizeable one-off spending in 2015. Revenues are set to increase by less than 1% in nominal terms, i.e. below the expected 1.7% growth in nominal GDP. This confirms a further slight reduction in the tax burden, following various cuts in the labour tax wedge and the abolition of the property tax on primary residences.

In 2017, the deficit is forecast to stabilise at 2.4% of GDP, as the reduction in the primary surplus is offset by further declining interest expenditure. The 2017 Draft Budgetary Plan (DBP) envisages additional pension expenditure. However, past pension reforms and a still modest rise in public wages is set to contain the increase in current primary expenditure. The DBP also introduces new measures to boost public investment, for instance through a preventive plan to increase the safety of buildings against seismic risks. By contrast, other capital expenditure is forecast to decline. This is also due to the planned one-off intake from the sale of broadband licences, which is recorded as lower capital spending. On the revenue side, the tax burden is set to further decline in 2017 mainly thanks to the reduction in the corporate income tax rate.

Under a no-policy change assumption, in 2018, the deficit is forecast to increase to 2.5% of GDP, also because of some further decline in the tax burden included in the DBP such as a flat tax regime for entrepreneurial income of small firms (IRI), otherwise subject to progressive personal income tax rates.

The high reliance on one-off revenues to finance the expansionary measures envisaged in the DBP contributes to a marked worsening of the structural balance in 2016 and 2017.

Italy's government debt-to-GDP ratio is set to increase to 133% in 2016 and then broadly stabilise at that level in 2017-2018, mainly thanks to progressively lower interest rates paid on debt and higher nominal GDP growth.

Table II.12.1:

Main features of country forecast - ITALY

	2015		Annual percentage change						
bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	1642.4	100.0	0.6	-1.7	0.1	0.7	0.7	0.9	1.0
Private Consumption	1001.8	61.0	0.8	-2.5	0.4	1.5	1.2	0.9	1.1
Public Consumption	311.0	18.9	0.8	-0.3	-0.9	-0.6	1.0	0.3	0.3
Gross fixed capital formation	273.4	16.6	0.3	-6.6	-3.0	1.3	2.1	2.6	3.2
of which: equipment	95.1	5.8	0.7	-8.2	0.9	4.3	4.5	4.5	4.2
Exports (goods and services)	493.7	30.1	2.2	0.7	2.9	4.3	1.7	2.8	3.3
Imports (goods and services)	443.1	27.0	2.7	-2.4	3.3	6.0	2.4	3.8	4.7
GNI (GDP deflator)	1633.3	99.4	0.6	-1.8	0.3	0.2	1.1	0.9	1.0
Contribution to GDP growth: Domestic demand			0.7	-2.8	-0.4	1.0	1.3	1.1	1.3
Inventories			0.0	0.2	0.6	0.1	-0.4	0.0	0.0
Net exports			0.0	0.9	0.0	-0.4	-0.1	-0.2	-0.3
Employment			0.3	-2.4	0.3	0.8	1.2	0.7	0.7
Unemployment rate (a)			8.7	12.1	12.7	11.9	11.5	11.4	11.3
Compensation of employees / f.t.e.			2.5	1.3	-0.2	0.4	0.0	0.4	1.5
Unit labour costs whole economy			2.2	0.6	0.0	0.5	0.5	0.2	1.2
Real unit labour cost			0.0	-0.6	-0.8	-0.2	-0.4	-0.7	0.0
Saving rate of households (b)			13.8	11.0	11.1	10.4	10.7	11.0	11.3
GDP deflator			2.2	1.2	0.9	0.6	1.0	0.9	1.3
Harmonised index of consumer prices			2.3	1.2	0.2	0.1	0.0	1.2	1.4
Terms of trade goods			-0.6	1.8	3.3	4.0	3.5	-0.7	-0.2
Trade balance (goods) (c)			0.6	2.2	2.9	3.2	3.7	3.4	3.1
Current-account balance (c)			-0.8	1.0	1.9	1.6	2.8	2.5	2.1
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.6	1.0	2.1	1.8	2.9	2.7	2.3
General government balance (c)			-3.2	-2.7	-3.0	-2.6	-2.4	-2.4	-2.5
Cyclically-adjusted budget balance (d)			-3.2	-0.5	-1.0	-1.2	-1.5	-1.9	-2.5
Structural budget balance (d)			-	-1.0	-1.2	-1.1	-1.6	-2.2	-2.4
General government gross debt (c)			107.6	129.0	131.9	132.3	133.0	133.1	133.1

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