

## 12. ITALY

### External demand and investment support modest recovery

Italy's economy is set to continue expanding by about 1% in 2017 and 2018, driven by stronger external demand and the recovery of investment. Equipment investment, in particular, should benefit from the extension of tax incentives and the accommodative monetary policy stance. Private consumption growth is projected to slow in 2017, due to the impact of slower employment growth and higher inflation on real disposable income. The general government deficit is expected to slightly decline in 2017, while the debt-to-GDP ratio is set to broadly stabilise over the forecast horizon.

#### Economic activity continued to expand in 2016

The recent modest economic recovery continued in 2016, when real GDP increased by 0.9% (up from 0.8% in 2015). The expansion of domestic demand was the main driver of growth. Equipment investment recorded a sizeable increase, supported by the accommodative monetary policy stance and by tax incentives. After eight years of contraction, construction investment rose only moderately, as the sector is still affected by financing constraints, and public investment declined. Private consumption continued to grow faster than real GDP mainly thanks to solid job creation, sustained by the implementation of labour market reforms and the reduction in the labour tax wedge. Exports and imports both decelerated compared with 2015, mirroring developments in global trade.

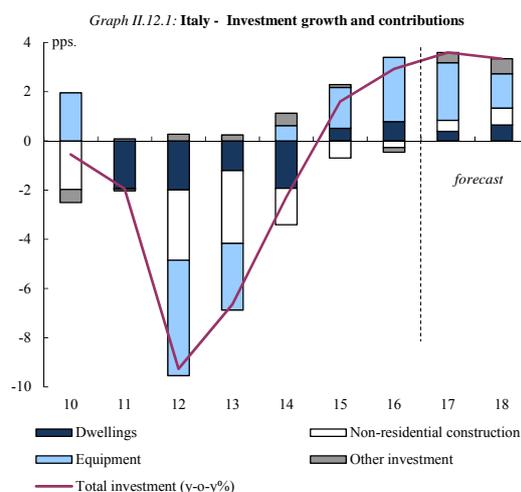
#### Exports and investment are supporting growth

In 2017, real GDP is projected to grow by 0.9%. Exports are set to accelerate, broadly in line with external demand developments. In turn, strong export growth should sustain the ongoing recovery in equipment investment. The latter is also expected to benefit from low real interest rates, the extension of tax incentives adopted with the 2017 budget, and the self-financing capacity of more profitable exporting firms. Construction investment is set to accelerate slightly, also thanks to more resources earmarked for public investment, a higher absorption of EU funds and the impact of the Investment Plan for Europe. However, financing constraints are likely to remain in place for the construction sector and SMEs. Private consumption growth is projected to almost halve in 2017 compared with 2015-2016, as higher inflation and slower employment growth weigh on household real disposable income.

In 2018, real GDP growth is set to increase slightly (by 1.1%) thanks to stronger exports, sustained investment dynamics, and more buoyant private consumption, which is also due to moderately

rising wages. The acceleration in export and investment growth is expected to trigger higher imports, implying that net exports will detract slightly from real GDP growth in both 2017 and 2018. This, together with higher imported energy prices, is set to lead to a gradual reduction in the current account surplus over the forecast horizon.

Political uncertainty and the slow adjustment in the banking sector represent downside risks to Italy's growth prospects. By contrast, the currently high confidence in manufacturing might imply stronger external demand than assumed in the forecast.



#### The unemployment rate declines marginally

After positive performances in 2015 and 2016, when employment was supported by a temporary reduction in social contributions, employment is expected to grow at a pace more consistent with economic developments in 2017 and 2018. Partly as a result of higher labour force participation, the unemployment rate is projected to remain above 11% over the forecast horizon. The sizeable slack remaining in the labour market is expected to contain wage pressures over the forecast horizon, with nominal unit labour costs rising by around 1% on average over 2017 and 2018.

### Headline inflation picks up

In the first quarter of 2017, headline annual HICP inflation rose to around 1.3%, following three years of near-zero inflation. Higher energy and unprocessed food prices are projected to lead to average annual inflation at 1.5% in 2017 and 1.3% in 2018. Core inflation was 0.6% in the first quarter of 2017 but it is expected to gradually accelerate over the forecast horizon on the back of moderate wage rises and a recovery in profit margins.

### A small deficit reduction in 2017

The general government deficit turned out at 2.4% of GDP in 2016, down from 2.7% in 2015, also thanks to lower interest expenditure. Current primary expenditure increased by 1.7% in nominal terms, also due to some exceptional transactions. Revenues remained broadly stable, implying a lower tax burden. This was mainly due to the lower labour tax wedge and the abrogation of the property tax on primary residences.

In 2017, the deficit is set to decline slightly to 2.2% of GDP. Current primary expenditure is expected to increase by around 1.5% in nominal

terms, also due to additional resources earmarked in the 2017 budget for pensions. However, past pension reforms and moderate increases in public wages and healthcare expenditure are still assumed to curb expenditure dynamics. The budget also supports public and private investment. Additional consolidation measures adopted in April, mainly to enhance tax compliance, are expected to maintain the tax burden stable despite the reduction in the corporate income tax rate to 24% from 27.5%.

In 2018, under a no-policy-change assumption, the deficit is forecast to slightly increase to 2.3% of GDP, also due to a lower tax burden. The 2017 budget includes measures with a deficit-increasing impact in 2018, such as the introduction of a flat tax on small firms' entrepreneurial income (IRI). The structural balance is set to slightly deteriorate both in 2017 and in 2018.

The general government debt-to-GDP ratio rose to 132.6% in 2016, mainly due to an increase in the liquidity buffer. A further slight increase is expected in 2017, also due to the additional resources earmarked for the public support to the banking sector and retail investors. The debt-to-GDP ratio is forecast to decline to 132.5% in 2018, under a no-policy-change assumption.

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
GDP	1645.4		100.0	0.6	-1.7	0.1	0.8	0.9	0.9	1.1
Private Consumption	1001.0		60.8	0.8	-2.5	0.3	1.6	1.4	0.8	1.0
Public Consumption	311.6		18.9	0.8	-0.3	-0.7	-0.7	0.6	0.2	0.0
Gross fixed capital formation	276.5		16.8	0.3	-6.6	-2.3	1.6	2.9	3.6	3.3
of which: equipment	96.9		5.9	0.7	-8.2	1.9	4.9	7.5	6.4	3.7
Exports (goods and services)	493.9		30.0	2.2	0.7	2.7	4.4	2.4	3.4	3.6
Imports (goods and services)	446.0		27.1	2.7	-2.4	3.2	6.8	2.9	4.5	4.7
GNI (GDP deflator)	1636.3		99.4	0.6	-1.8	0.3	0.2	1.6	0.9	1.1
Contribution to GDP growth:										
		Domestic demand		0.7	-2.8	-0.4	1.1	1.4	1.1	1.2
		Inventories		0.0	0.2	0.6	0.2	-0.5	0.0	0.1
		Net exports		0.0	0.9	-0.1	-0.5	-0.1	-0.2	-0.2
Employment				0.3	-2.4	0.2	1.0	1.4	0.7	0.8
Unemployment rate (a)				8.7	12.1	12.7	11.9	11.7	11.5	11.3
Compensation of employees / f.t.e.				2.5	1.3	0.0	0.2	0.3	0.9	1.6
Unit labour costs whole economy				2.2	0.6	0.1	0.4	0.8	0.6	1.3
Real unit labour cost				0.0	-0.6	-0.9	-0.2	0.0	-0.2	0.0
Saving rate of households (b)				13.8	11.0	11.2	10.5	10.6	10.4	10.4
GDP deflator				2.2	1.2	1.0	0.7	0.8	0.8	1.2
Harmonised index of consumer prices				2.3	1.2	0.2	0.1	-0.1	1.5	1.3
Terms of trade goods				-0.6	1.8	3.5	4.1	3.2	-2.4	0.1
Trade balance (goods) (c)				0.6	2.2	2.9	3.1	3.6	2.9	2.8
Current-account balance (c)				-0.8	1.0	1.9	1.4	2.6	1.9	1.7
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.6	0.9	2.1	1.6	2.5	1.8	1.6
General government balance (c)				-3.2	-2.9	-3.0	-2.7	-2.4	-2.2	-2.3
Cyclically-adjusted budget balance (d)				-3.2	-0.7	-1.0	-1.2	-1.5	-1.8	-2.3
Structural budget balance (d)				-3.9	-0.9	-1.2	-1.0	-1.7	-2.0	-2.2
General government gross debt (c)				107.6	129.0	131.8	132.1	132.6	133.1	132.5

(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.