12. ITALY

Moving towards more self-sustaining growth

The cyclical recovery of the Italian economy started in 2015 and it is expected to strengthen in 2016 and 2017 as oil prices remain low and domestic demand warms up. Inflation is forecast to rise very gradually as labour cost pressures remain limited. In 2016, the government structural balance is expected to deteriorate while the debt-to-GDP ratio declines slightly.

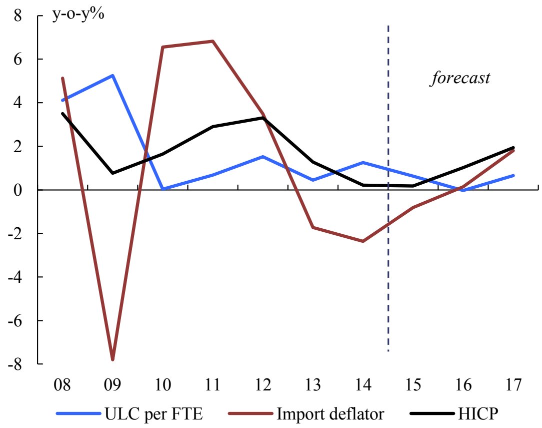
The cyclical recovery is set to strengthen…

In the first half of 2015, Italy's economy started a recovery supported by positive external factors including weaker euro and lower oil prices. Real GDP is anticipated to grow by 0.9% in 2015 (after contracting by 0.4% in 2014) as recent indicators point to further expansion in the second half of the year despite the global trade slowdown. Financing conditions are gradually improving as shown by the yearly increase in the stock of credit to households and manufacturing firms in recent months. The contraction of credit to firms in other sectors has also markedly slowed down since the start of the year. In 2016, real GDP is expected to increase by 1.5 % driven by domestic demand. Low inflation, employment growth and tax cuts are set to support real disposable income and thus private consumption. While the recovery in construction is expected to be gradual, new equipment investment is set to pick-up as demand strengthens, spare capacity wanes and profit margins increase. Although non-performing loans still burden bank balance sheets, credit conditions are set to normalise in 2016 as monetary policy remains accommodative and credit is channelled to more productive firms. Moreover, sound non-financial corporations are in a position to self-finance investments as they have been net lenders in the economy since 2012 and deleveraging needs diminish. Economic expansion is set to continue in 2017 at 1.4% as higher imports compensate for higher external demand and investment. The current-account surplus is set to decline from 2.2% of GDP in 2015 to 1.9% of GDP in 2016-17 with the expected increase in savings more than offset by higher investment. A further slowdown in global demand poses however downside risks.

…and employment to increase…

A three-year social contribution exemption for new permanent hires made in 2015 supported the increase in headcount employment seen in the first half of the year. This is set to continue over the rest of 2015. The 2016 Draft Budgetary Plan (DBP) extends this scheme to new permanent hires made in 2016, but with partial exemption (40%). As recovery gathers strength, employment is thus projected to continue increasing in 2016 and 2017, but more in working hours than in headcount terms. The unemployment rate is set to decline only gradually 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 are expected to be discounted in future bargaining rounds. Low wage dynamics and improving labour productivity lead to slight increases in nominal unit labour costs.

Graph II.12.1: **Italy - HICP inflation and its main determinants**



…while inflation remains low.

In 2015, HICP inflation is forecast to stabilise at 0.2% as a fall in imported energy prices is offset by a moderately positive core inflation (0.8%). HICP inflation is expected to rise to 1.0% in 2016 and to accelerate to 1.9% in 2017 also due to a new increase in VAT (standard rate by 2 pps. and reduced rate by 3 pps.) foreseen in the DBP to achieve the budgetary targets in that year, unless alternative compensatory measures are found. A similar pattern is anticipated for core inflation (0.9% in 2016 and 1.7% in 2017), driven by very limited wage pressures and some recovery in profit margins after their squeeze during the crisis.

The headline government deficit declines

In 2015, the deficit is projected to decline to 2.6% of GDP (from 3.0% in 2014), supported by a further drop in interest expenditure and a marginally higher primary surplus stemming from positive economic growth. Primary expenditure is set to continue rising at a slow pace. More specifically, current primary expenditure is projected to increase by less than 1% y-o-y in nominal terms, thanks to the expenditure cuts legislated in the 2015 Stability Law and the ongoing wage freeze. However, this is partially offset by the additional spending related to the tax credit to low-wage employees, the extension of unemployment benefits, and new hiring in the education system. Outlays related to the migrant influx are estimated by the government at around 0.2% of GDP, marginally higher than in 2014 and more than twice as in the years 2011-13. Regarding capital expenditure, public investment is set to stabilise after five years of significant contraction. Capital transfers are expected to increase relative to 2014 also due to one-off outlays (around EUR 2 bn.) related to the Constitutional Court ruling about the full de-indexation of higher pensions over 2012 and 2013. On the revenue side, the better economic outlook implies positive developments for personal and corporate income tax revenues. However, the reduction in the labour tax wedge is expected to affect intakes from the regional tax on economic activities (IRAP) and social contributions. Overall, annual revenue increases are projected to be in line with nominal GDP growth. In 2015, the structural balance is set to improve slightly relative to 2014. In 2016, after incorporating the expected impact of the DBP, the deficit is projected to narrow only slightly (to 2.3% of GDP vs. 2.2% in the DBP) despite the positive growth outlook. This results in a deterioration of the structural balance of around ½ pps. of GDP. On the expenditure side, the additional net savings in the DBP are forecast to curb the dynamics of primary expenditure, which is set to nearly stabilise in nominal terms. On the revenue side, taxation is forecast to increase much less than nominal GDP as a result of the reduction in the labour tax wedge and property taxation. As a result, the tax burden is set to fall by nearly 1 pp. of GDP relative to 2015. In 2017, the headline deficit is projected to continue declining (to 1.6% of GDP) based on a no-policy-change assumption. The government debt-to-GDP ratio is set to decrease in 2016 and 2017, thanks to higher nominal growth and primary surplus.

Table II.12.1:

Main features of country forecast - ITALY

	2014			Annual percentage change						
bn EUR	Curr. prices	% GDP	96-11	2012	2013	2014	2015	2016	2017	
GDP	1613.9	100.0	0.9	-2.8	-1.7	-0.4	**0.9**	**1.5**	**1.4**	
Private Consumption	986.3	61.1	1.1	-3.9	-2.7	0.4	**0.8**	**1.4**	**0.7**	
Public Consumption	315.3	19.5	1.0	-1.4	-0.3	-0.7	**0.0**	**0.1**	**1.0**	
Gross fixed capital formation	268.1	16.6	1.1	-9.3	-6.6	-3.5	**1.2**	**4.0**	**4.8**	
of which: equipment	87.4	5.4	1.7	-13.6	-7.3	-2.9	**4.5**	**6.5**	**7.3**	
Exports (goods and services)	477.2	29.6	2.2	2.3	0.8	3.1	**4.4**	**3.3**	**4.5**	
Imports (goods and services)	428.4	26.5	3.2	-8.1	-2.5	2.9	**5.0**	**4.8**	**5.0**	
GNI (GDP deflator)	1613.4	100.0	0.9	-2.7	-1.8	-0.2	**0.9**	**1.5**	**1.4**	
Contribution to GDP growth: Domestic demand			1.0	-4.5	-2.9	-0.5	**0.7**	**1.5**	**1.4**	
Inventories			0.0	-1.2	0.3	-0.1	**0.2**	**0.2**	**0.0**	
Net exports			-0.2	2.9	0.9	0.1	**0.0**	**-0.3**	**0.0**	
Employment			0.4	-1.4	-2.5	0.2	**1.0**	**1.0**	**1.0**	
Unemployment rate (a)			8.8	10.7	12.1	12.7	**12.2**	**11.8**	**11.6**	
Compensation of employees / f.t.e.			2.9	0.4	1.5	0.6	**0.5**	**0.4**	**1.1**	
Unit labour costs whole economy			2.4	1.9	0.7	1.3	**0.6**	**0.0**	**0.7**	
Real unit labour cost			0.1	0.5	-0.6	0.4	**0.2**	**-1.0**	**-1.1**	
Saving rate of households (b)			14.5	9.4	11.3	10.8	**11.0**	**11.1**	**11.3**	
GDP deflator			2.4	1.4	1.3	0.9	**0.4**	**1.0**	**1.8**	
Harmonised index of consumer prices			2.3	3.3	1.3	0.2	**0.2**	**1.0**	**1.9**	
Terms of trade goods			-0.4	-1.4	1.7	3.0	**2.4**	**0.5**	**0.0**	
Trade balance (goods) (c)			0.8	1.0	2.2	3.0	**3.2**	**2.9**	**2.9**	
Current-account balance (c)			-0.6	-0.4	0.9	2.0	**2.2**	**1.9**	**1.9**	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.5	-0.2	1.0	2.2	**2.5**	**2.3**	**2.1**	
General government balance (c)			-3.4	-3.0	-2.9	-3.0	**-2.6**	**-2.3**	**-1.6**	
Cyclically-adjusted budget balance (d)			-3.5	-1.2	-0.6	-0.9	**-1.0**	**-1.5**	**-1.5**	
Structural budget balance (d)			-	-1.3	-0.9	-1.1	**-1.0**	**-1.5**	**-1.4**	
General government gross debt (c)			107.1	123.2	128.8	132.3	**133.0**	**132.2**	**130.0**	

(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.