12. ITALY

Economy slowly regaining pace amid high fiscal imbalances

Italy's economy slipped into a mild contraction in the second half of last year, as the slowdown of global trade and weak manufacturing spread to the domestic economy. This weakness is set to give way to a muted recovery, as growth is likely to rebound moderately on the back of firming external demand and higher social transfers. Subdued economic growth and fiscal loosening are expected to affect public finances, with both government deficit and debt projected to increase substantially over the forecast horizon. Consumer price inflation is set to decelerate this year and pick up moderately in 2020.

The economy shows signs of bottoming out

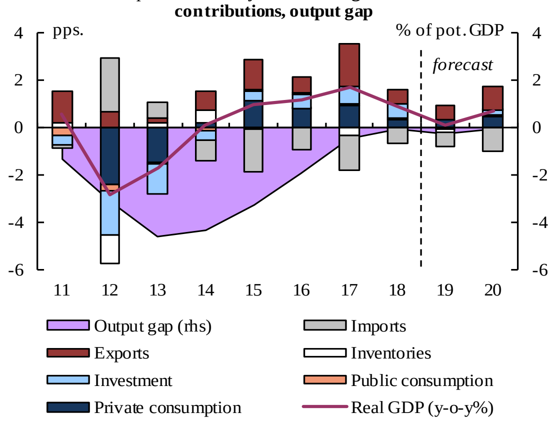
Real GDP growth went into reverse in the second half of 2018 and the economy slipped into a mild contraction. For the year as a whole, real output expanded by 0.9%, supported by domestic demand, while net exports weighed on real GDP growth. Given positive signs from short-term indicators, economic activity is set to pick up in early 2019. However, still subdued business and consumer sentiment suggests that output growth will gain more traction only later in the year. For the year as a whole, real GDP growth is expected to remain sluggish at 0.1%. In 2020, which has two additional working days, real GDP is forecast to expand by 0.7%. The forecast scenario is based on a no-policy-change assumption and does not incorporate the effects of hikes in indirect taxes envisaged for 2020 in the government plans.

External demand and private consumption to underpin return to growth

Aggregate domestic demand is unlikely to lend much support to growth in 2019, as a drop in investment demand will largely offset the positive impact from moderate consumer spending. Capital spending is expected to bear the brunt of policy uncertainty both at the domestic and international level. However, the re-introduction of investment-related tax incentives that were cancelled at the end of last year is likely to slow the decline in business investment. Private consumption growth should be helped by the positive impact of lower inflation on real disposable incomes and the introduction of the citizenship income. However, a deteriorating labour market is set to dampen consumer spending, and declining consumer confidence suggests that some of the expected rise in incomes could be diverted to savings. Assuming that global growth picks up in the second half of 2019, exports are set to become a major growth driver over the forecast period and Italian exporters are expected to limit their losses in market shares.

Risks to the growth outlook remain predominantly negative, as trade tensions continue to cloud the global outlook and higher-than-expected oil prices could curb consumers' purchasing power. In addition, financial markets remain very sensitive to policy changes and any possible related increases in sovereign yields could affect sentiment and private-sector funding conditions. By contrast, a better-than-expected external environment could imply a stronger export-led rebound.

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



Labour market to weaken considerably

The labour market is unlikely to escape the impact of sluggish economic activity, as indicated by firms' subdued employment expectations. Employment growth is expected to grind to a halt in 2019. The unemployment rate is forecast to climb close to 11% this year, as the new citizenship income scheme is likely to induce more people to officially register as unemployed and thus be counted in the labour force.

Consumer price inflation remains muted

After having risen by 1.2% in 2018, consumer prices are set to increase by only 0.9% this year, partly due to lower energy prices, and by 1.1% in 2020. Core inflation, at 0.5% in March 2019, is forecast to rise above 1% by the end of 2020.

Weak growth and fiscal loosening weigh on public finances

Following extraordinary costs to support the banking sector in 2017, the general government headline deficit declined from 2.4% to 2.1% of GDP in 2018, supported by rising revenues. Government spending for the compensation of employees slightly increased due to a moderate increase in public wages, while public investment spending declined markedly.

In 2019, the general government deficit is expected to increase to 2.5% of GDP, mainly due to the slowdown in economic growth. In particular, weak labour market developments are expected to substantially curb revenues from direct taxes. The latter are also lowered by the deferred impact of past tax measures. Those developments will be only partially offset by several changes in the tax regime introduced by the 2019 budget, which should provide temporary support for revenues. Government spending is set to increase significantly following the introduction of the citizenship income and several provisions on pensions, including a new early retirement scheme. Some savings are expected from a new spending review. These projections also assume a cut in government spending of around 0.1% of GDP legislated as a budgetary safeguard clause in 2019.

In 2020, the government deficit is projected to reach 3.5% of GDP, under a no-policy-change assumption. This forecast does not consider the increase in VAT rates legislated as a safeguard clause, given past repeals and government announcements. The delayed impact of the new tax regimes implemented in 2019, higher funds for public investment and additional spending for the citizenship income and the early retirement scheme are expected to be only marginally offset by strengthened provisions against tax evasion and temporary revenues from a new tax amnesty.

The structural balance is expected to deteriorate from around -2¼% of GDP in 2018 to -3½% of GDP in 2020. As the result of a lower primary surplus and a positive interest-rate/growth-rate differential, Italy's debt-to-GDP ratio is forecast to increase from 132.2% in 2018 to 135.2% in 2020.

Renewed tensions on sovereign yields constitute a risk to these fiscal projections. Conversely, the possible activation of the VAT safeguard clause in 2020 and potential underspending for the new measures would lead to a better fiscal outlook.

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	1727.4	100.0	0.3	0.9	1.1	1.7	**0.9**	**0.1**	**0.7**
Private Consumption	1049.5	60.8	0.2	1.9	1.3	1.6	**0.6**	**0.6**	**0.8**
Public Consumption	323.2	18.7	0.7	-0.6	0.1	0.3	**0.2**	**-0.1**	**0.5**
Gross fixed capital formation	303.7	17.6	-0.6	2.1	3.5	4.3	**3.4**	**-0.3**	**0.9**
of which: equipment	114.6	6.6	-0.5	4.6	6.7	9.1	**5.5**	**-0.5**	**0.8**
Exports (goods and services)	538.3	31.2	1.9	4.4	2.1	5.9	**1.9**	**1.9**	**3.1**
Imports (goods and services)	488.0	28.3	1.6	6.8	3.6	5.5	**2.3**	**2.2**	**3.3**
GNI (GDP deflator)	1735.6	100.5	0.3	0.2	2.1	1.9	**1.3**	**0.5**	**0.7**
Contribution to GDP growth:	Domestic demand		0.2	1.4	1.4	1.7	**1.0**	**0.3**	**0.7**
	Inventories		0.0	0.1	0.0	-0.4	**0.0**	**-0.1**	**0.0**
	Net exports		0.1	-0.5	-0.3	0.3	**-0.1**	**0.0**	**0.0**
Employment			0.1	0.7	1.3	0.9	**0.8**	**-0.1**	**0.5**
Unemployment rate (a)			8.9	11.9	11.7	11.2	**10.6**	**10.9**	**11.0**
Compensation of employees / f.t.e.			2.4	1.0	0.3	0.3	**2.0**	**0.9**	**1.0**
Unit labour costs whole economy			2.2	0.7	0.5	-0.5	**1.9**	**0.7**	**0.8**
Real unit labour cost			0.2	-0.2	-0.7	-1.0	**1.1**	**0.1**	**-0.2**
Saving rate of households (b)			13.1	10.6	10.5	9.7	**9.9**	**10.0**	**9.9**
GDP deflator			2.0	0.9	1.2	0.5	**0.8**	**0.7**	**1.0**
Harmonised index of consumer prices			2.1	0.1	-0.1	1.3	**1.2**	**0.9**	**1.1**
Terms of trade goods			-0.5	4.2	3.6	-2.3	**-1.6**	**-0.5**	**0.0**
Trade balance (goods) (c)			0.6	3.1	3.4	3.2	**2.7**	**2.6**	**2.6**
Current-account balance (c)			-0.8	1.3	2.5	2.5	**2.4**	**2.5**	**2.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.7	1.7	2.3	2.6	**2.4**	**2.5**	**2.5**
General government balance (c)			-3.2	-2.6	-2.5	-2.4	**-2.1**	**-2.5**	**-3.5**
Cyclically-adjusted budget balance (d)			-3.0	-0.8	-1.5	-2.1	**-2.1**	**-2.3**	**-3.4**
Structural budget balance (d)			-3.6	-0.7	-1.7	-2.1	**-2.2**	**-2.4**	**-3.6**
General government gross debt (c)			109.8	131.6	131.4	131.4	**132.2**	**133.7**	**135.2**

(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.