11. ITALY

Uncertainty and tight financing conditions delay recovery

A deep recession in 2012...

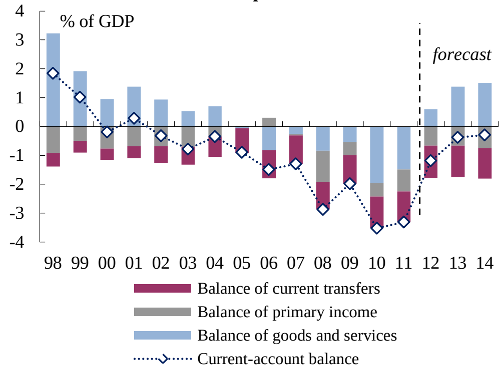
In 2012, the Italian economy is expected to contract by 2.3% on the back of a sharp fall in domestic demand, especially in investment. Uncertainty in financial markets remains elevated, continuing to affect economic agents' confidence and their investment and spending decisions. Furthermore, the protracted euro-area sovereign-debt crisis has exerted significant upward pressure on interest rates. In the context of a fragmented financial sector across national borders, this has fed into funding pressures in the banking sector and tighter financing conditions for the private sector. In turn, credit tightening may amplify the dampening impact of the sizeable fiscal consolidation on domestic demand. Finally, the deteriorated external economic environment has tapered the expansion of exports, even though the trade balance is set to return to positive territory in 2012 as imports decline significantly.

...followed by a tepid recovery

Under the assumption of a gradual normalisation of financial market conditions and reduced uncertainty, the pace of contraction of economic activity is set to decelerate in the second half of 2012, following two consecutive quarters of real GDP growth at -0.8%. Economic activity is expected to start growing again as from the second half of 2013, but at a very subdued pace. For 2013 as a whole, private consumption is set to contract further and return into positive territory only in 2014, in line with real disposable income developments. Investment in equipment is expected to recover faster, as financing conditions and confidence improve, while the correction in the construction sector is forecast to continue into 2014. The expected acceleration in Italy's export markets and the euro depreciation that occurred in 2012 are set to lead to stronger export growth in 2013, in particular towards non-EU trade partners. Depressed domestic demand would continue curbing imports in 2013, while in 2014 their rebound is expected to outpace growth of exports due to the recovery in domestic demand, in particular for investment in equipment.

Overall, the trade balance is set to remain positive, also thanks to the assumed reduction in oil prices over the whole forecast horizon. Therefore, the current-account deficit is forecast to narrow to less than ½% of GDP over 2013-14.

Graph II.11.1: **Italy - Determinants of the current-account position**



Higher unemployment and wage moderation

On the back of the ongoing recession, the unemployment rate is expected to increase by over 2 pps., entering double-digit territory, in 2012, and by another percentage point over 2013-14. This trend continues to be mainly driven by an expanding labour force. Two major factors can be held to explain the significant increase in labour market participation since mid-2011. On the one hand, more individuals, in particular women and young people, are now impelled to look for jobs as households' disposable income falls. On the other hand, the recently adopted pension reforms are pushing older workers to remain in the labour market. Moreover, after increasing slightly in 2011, headcount employment is expected to decline in 2012 and 2013, even though job losses in 2012 are held back by some labour hoarding by firms.

Hours worked are projected to fall significantly more in 2012-13, and recover relatively faster in 2014, owing to the firms' increased use, during the recession, of the wage supplementation scheme and part-time work. When measured in terms of full-time equivalent employment, labour productivity is projected to fall in 2012, and start increasing again, but only moderately, in 2013-14. Wages in the private sector are expected to grow below inflation over the forecast horizon, while public sector wages continue to be frozen. As a result, nominal unit labour costs are forecast to accelerate in 2012, increasing by more than 2%, before slowing down below 1% over 2013-14. Taken together with the depreciation of the nominal effective exchange rate in 2012, Italy is expected to recover some cost competitiveness over the forecast horizon, in particular vis-à-vis its non-EU trade partners.

Indirect taxes and oil prices shape inflation developments

Annual HICP inflation remained above 3% in the first three quarters of 2012 due to higher oil prices and the increases in excise duties on fuel and the standard VAT rate that were enacted in 2011. Annual inflation is expected to ease at the end of 2012, thanks to the favourable base effect. A further 1 pp. increase in the standard and reduced VAT rates scheduled for July 2013 will push prices up again in the third quarter of 2013. Inflation is expected to go well below 2% in the second half of 2014 due to the assumed decline in oil prices and reduced pressure from labour costs.

Fiscal consolidation continues only until 2013

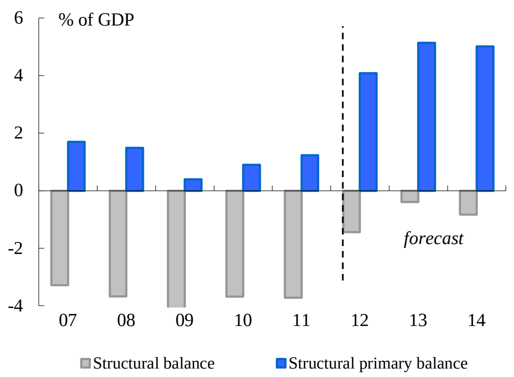
Despite the sharp economic downturn, the general government deficit is projected to narrow to 2.9% of GDP in 2012, from 3.9% in 2011, and to 2.1% in both 2013 and 2014. The projected increase in interest expenditure over the forecast period reflects the sharp increase in the sovereign-risk premium in the second half of 2011, as well as an increasing debt. It implies that the primary surplus improves more significantly than the overall general government balance, on the back of the sizeable consolidation measures adopted in 2010 and 2011: from 1% of GDP in 2011, the primary surplus is set to reach 3.7% in 2014.

In 2012, total primary expenditure is expected to decline slightly year-on-year (for the third year in a row) thanks to the expenditure saving measures adopted since May 2010, including in the context of the spending review in the summer 2012. The public sector wage bill has been significantly restrained through a 4-year freeze in wages and a quasi-total suspension of new hires. In addition, intermediate consumption has been cut at both central and local government levels. Social transfers are projected to increase only mildly: while the number of pensioners continues to rise, the pace of increase is set to continue declining thanks to the enacted pension reforms. De-indexation of higher pensions in 2012 and 2013 also contributes to the moderation of social transfer expenditure. On the capital side, direct investment and transfers are both expected to contract significantly, but the reduction in total capital expenditure is tempered by the proceeds of the sale of broadband licences, which are recorded as negative capital asset sales in 2011.

Despite the expected large contraction in domestic demand, revenues are projected to rise substantially as a share of GDP in 2012, by 2 pps. from 2011, thanks to the adopted discretionary measures. The increase in the standard VAT rate (from 20% to 21%), in excise duties on fuel and especially in taxation on property enacted in 2011 are anticipated to more than offset the fall in tax revenues entailed by both the negative income dynamics and the large fall in consumption, notably of tax-rich durable goods. At the same time, the expiry of one-off taxes in 2012 is bound to reduce the capital revenue intake relative to 2011.

The structural adjustment in 2012 is estimated at nearly 2¼ pps. of GDP for the overall balance and around 2¾ pps. for the primary balance.

*Graph II.11.2:***Italy - General government structural balances**



In 2013-14, the forecast incorporates the expenditure savings enacted in the summer 2012 and with the 3-year draft budget law (*Legge di Stabilità 2013-15*) adopted by the government in October. These savings are also intended to finance part of the repeal of the VAT rates' increase legislated in December 2011. Current primary expenditure is projected to rise only marginally in nominal terms in 2013, but to resume growing at a faster pace in 2014 as the de-indexation of higher pensions expires. Capital spending is set to continue falling in 2013 and then recover slightly in 2014. Total primary expenditure in nominal terms is thus expected to decline for the fourth consecutive year in 2013 and increase slightly in 2014. By contrast, interest expenditure is set to continue increasing, although at a slower pace than in 2012 due to the assumed normalisation in financial markets and the levelling-off of the debt-to-GDP ratio.

The draft budget contains a number of measures on the revenue side. In a second move aimed at lessening the VAT rates' increase that was legislated in December 2011, the standard and reduced rates are now set to increase by 1 pp. as from July 2013. The further temporary increase in excise duties on fuels that was enacted in the summer 2012 is made permanent, while a new tax on financial transactions is introduced. This, together with the full coming into force of the increase in property taxation enacted in 2011, is expected to boost indirect tax revenues in 2013. By contrast, despite the increase in the tax base, revenue from direct taxes is set to remain stable. Tax rates on personal income up to EUR 28,000 per year are reduced by 1 pp., while some tax expenditure is cut. Moreover, the tax incentives on performance-related pay are prolonged. In 2014, the increase in current tax revenues is projected to decelerate as no further discretionary increase in taxation is planned. As a share of GDP, total revenues are expected to peak in 2013 and decrease somewhat in 2014.

The structural balance is expected to improve further in 2013 – by around 1 pp. of GDP – and achieve a budgetary position close to balance. Under a no-policy-change assumption, the structural balance is anticipated to depart from this position in 2014. The structural primary surplus is estimated to rise to above 5% of GDP in 2013 and broadly stabilise in 2014.

Gross government debt is projected to increase significantly as a share of GDP in 2012 and 2013, mainly due to the fall in real GDP and the impact of the financial support to other euro-area countries. The debt-to-GDP ratio is set to start decreasing in 2014, as macroeconomic conditions improve and the primary surplus increases further. The proceeds expected by the government from the planned privatisation programme over 2013-15 (1 pp. of GDP per year) are not included in the forecast, as at the cut-off date the details needed to estimate its impact had not yet been spelled out.

Table II.11.1:

Main features of country forecast - ITALY

	2011			Annual percentage change					
	bn EUR Curr. prices	**% GDP**	**92-08**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
GDP	1579.7	100.0	1.3	-5.5	1.8	0.4	**-2.3**	**-0.5**	**0.8**
Private consumption	969.0	61.3	1.2	-1.6	1.2	0.1	**-3.4**	**-0.9**	**0.9**
Public consumption	323.4	20.5	0.9	0.8	-0.6	-0.8	**-0.7**	**-0.3**	**-0.4**
Gross fixed capital formation	308.9	19.6	1.2	-11.7	2.1	-1.8	**-8.1**	**-2.1**	**2.6**
of which : equipment	132.3	8.4	1.8	-16.8	12.0	-1.1	**-10.9**	**-0.6**	**6.3**
Exports (goods and services)	455.6	28.8	4.5	-17.5	11.4	6.0	**1.1**	**3.0**	**4.1**
Imports (goods and services)	479.0	30.3	3.9	-13.4	12.5	0.6	**-7.2**	**1.4**	**5.0**
GNI (GDP deflator)	1567.6	99.2	-	-4.9	1.8	0.1	**-2.2**	**-0.5**	**0.8**
Contribution to GDP growth : Domestic demand			1.1	-3.2	1.0	-0.4	**-3.8**	**-1.0**	**1.0**
Inventories			0.1	-1.2	1.2	-0.5	**-1.0**	**0.0**	**0.1**
Net exports			0.2	-1.1	-0.3	1.4	**2.5**	**0.5**	**-0.2**
Employment			0.3	-2.9	-0.9	0.1	**-1.3**	**-1.0**	**0.4**
Unemployment rate (a)			9.2	7.8	8.4	8.4	**10.6**	**11.5**	**11.8**
Compensation of employees/f.t.e.			3.3	1.7	2.3	1.2	**1.1**	**1.3**	**1.2**
Unit labour costs whole economy			2.3	4.6	-0.4	0.9	**2.2**	**0.8**	**0.8**
Real unit labour costs			-0.7	2.4	-0.8	-0.4	**0.7**	**-0.8**	**-0.8**
Saving rate of households (b)			18.3	14.2	12.7	12.0	**12.4**	**12.4**	**12.4**
GDP deflator			3.0	2.1	0.4	1.3	**1.4**	**1.6**	**1.6**
Harmonised index of consumer prices			3.0	0.8	1.6	2.9	**3.3**	**2.0**	**1.7**
Terms of trade of goods			-0.6	7.4	-3.9	-3.9	**-1.5**	**1.0**	**1.5**
Merchandise trade balance (c)			1.5	0.1	-1.3	-1.1	**0.8**	**1.6**	**1.8**
Current-account balance (c)			0.2	-2.0	-3.5	-3.3	**-1.2**	**-0.4**	**-0.3**
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			0.3	-2.0	-3.6	-3.3	**-1.2**	**-0.4**	**-0.3**
General government balance (c)			-4.4	-5.4	-4.5	-3.9	**-2.9**	**-2.1**	**-2.1**
Cyclically-adjusted budget balance (c)			-4.8	-3.6	-3.5	-3.0	**-1.3**	**-0.4**	**-0.9**
Structural budget balance (c)			-	-4.3	-3.7	-3.7	**-1.4**	**-0.4**	**-0.8**
General government gross debt (c)			110.4	116.4	119.2	120.7	**126.5**	**127.6**	**126.5**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.