8. ITALY

Real GDP growth is forecast to moderate to 2.4% this year and slowing to 1.9% in 2023, as spill-over effects from Russia's military aggression against Ukraine exacerbate existing supply-chain disruptions and price pressures. The inflation rate is set to climb to close to 6% this year and averaging 2.3% in 2023. Government deficit and debt are projected to decline to 4.3% and 146.8% by 2023, as pandemic-related policy support is phased-out, but to remain at high levels.

Geopolitical tensions impact outlook while pandemic-related drag fades

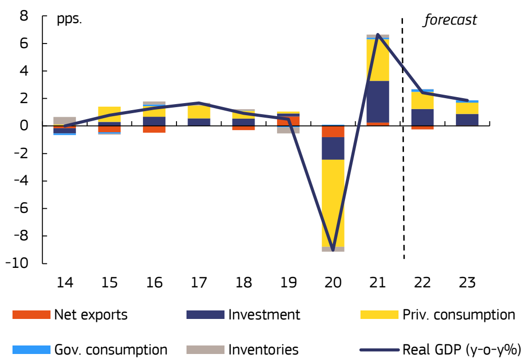
Italy's economy navigated well the prolonged COVID-19 pandemic in 2021, when real output rebounded by 6.6%. However, rising input prices and supply bottlenecks started to weigh on industrial activity in the second half of 2021, while rapidly rising energy prices dented households' purchasing power. Real GDP contracted in the first quarter of 2022 and the short-term outlook remains subdued, as the economic repercussions of Russia's military aggression against Ukraine have dented economic sentiment and exacerbated existing obstacles to expansion. The economy should return to a more sustained expansion path next year, thanks to investment financed by the RRF.

Real GDP growth is forecast to slow to 2.4% this year, with most of annual growth attributable to a carryover effect, due to the brisk recovery of 2021. The economy's return to pre-crisis output levels is thus postponed to the second half of 2022. In 2023, economic growth is expected to moderate to 1.9%, which is still sizeably above the long-term average. The outlook remains subject to pronounced downside risks. Namely, as one of the largest importers of Russian natural gas among EU countries, Italy would be severely affected by abrupt supply disruptions.

Domestic demand supports growth amid strengthening headwinds

Rising employment and high savings, albeit accumulated by wealthier households with a lower propensity to consume, are likely to support private consumption. Still, rising consumer prices coupled with sluggish wage growth are set to weigh on households' real disposable incomes and thus growth in consumer spending. In 2021, the investment-to-GDP ratio reached the highest level since 2010 and capital spending is set to remain solid on the back of RRF-financed investment. Yet, a weaker demand outlook and worsening financing conditions are expected to dampen corporate investment. Exports are forecast to grow in line with slowing growth in external demand, while the energy-related negative terms-of-trade effect is set to curb the current account surplus. The recovery in tourism is projected to support services exports but is unlikely to reach pre-crisis levels before 2023.

Graph II.8.1: **Italy - Real GDP growth and contributions**



Job market in lockstep with slowing activity

The pace of employment growth is expected to be in line with slowing economic activity, also indicated by firms' subdued employment expectations. Despite a significant reduction in the use of short-time work schemes, labour market slack remains sizeable, as both hours worked and headcount employment are projected to reach pre-pandemic levels only by the end of the forecast horizon. The unemployment rate is set to drop to 8.9% by 2023, amid an increasing labour force.

Tight commodity markets spur price pressure

Sharply rising energy and food prices are set to lift HICP inflation to almost 6% in 2022 with price pressures expected to broaden further. With input prices and inflation expectations at historically high levels, rising selling prices are set to keep inflation above 2% in 2023, despite a waning impact from energy prices. By contrast, wage growth is expected to remain moderate, as several wage contracts were already renewed just before the onset of the energy price surge in mid-2021. The GDP deflator is projected to rise by 3.1% this year, partly dampened by soaring import prices.

While improving, general government deficit projected to remain high

The government headline deficit decreased from 9.6% of GDP in 2020 to 7.2% in 2021. Fiscal revenues increased markedly, reflecting the rebound in economic activity, in particular private consumption. Moreover, government primary current expenditure decreased significantly as a share of GDP, also thanks to the phasing out of part of the pandemic-related fiscal measures. However, capital expenditure rose strongly, reflecting both higher public investment and grants for private investment.

The general government deficit is projected to decline further to 5.5% of GDP in 2022, due to higher revenues driven by economic growth and the unwinding of most of the pandemic emergency fiscal measures. At the same time, the measures included in the 2022 budget imply a deficit-increasing impact of around 1.2% of GDP in 2022. Additional fiscal support packages were adopted in the first months of this year, including measures aimed at mitigating the impact of higher energy costs on firms' and households' budgets as well as supporting firms operating in sectors still hit by the pandemic. Part of these costs are expected to be offset by spending cuts and revenue increases, including an extraordinary tax on energy companies. The 2022 Stability Programme announced further new measures with a net deficit-increasing impact of around 0.3% of GDP in 2022. They are however not included in the forecast as details were not available before the cut-off date.

Public investment is set to increase substantially, also due to projects supported by the RRF, while interest expenditure is expected to remain stable at 3.5% of GDP. Outlays related to the inflow of people fleeing Ukraine are estimated to increase expenditure by around 0.1% of GDP in 2022. In 2023, the government deficit is set to narrow to 4.3% of GDP, thanks to declining government spending and accelerating revenue growth.

The debt-to-GDP ratio is forecast to follow a downward trend over the forecast horizon. From 155.3% of GDP in 2020, it declined to 150.8% in 2021 due to the economic recovery and a favourable stock-flow adjustment. It is expected to reach 146.8% by 2023.

Table II.8.1:

Main features of country forecast - ITALY

		2021		Annual percentage change						
		bn EUR Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP		1775.4	100.0	0.0	0.9	0.5	-9.0	**6.6**	**2.4**	**1.9**
Private Consumption		1025.8	57.8	0.2	0.9	0.2	-10.6	**5.2**	**2.2**	**1.4**
Public Consumption		351.5	19.8	0.0	0.1	-0.5	0.5	**0.6**	**0.9**	**0.9**
Gross fixed capital formation		353.5	19.9	-0.9	3.1	1.2	-9.1	**17.0**	**6.2**	**4.1**
Exports (goods and services)		581.3	32.7	1.8	2.1	1.6	-13.4	**13.3**	**4.9**	**4.3**
Imports (goods and services)		538.3	30.3	1.5	3.4	-0.7	-12.1	**14.2**	**6.1**	**4.2**
GNI (GDP deflator)		1796.8	101.2	0.1	1.5	0.2	-8.7	**6.6**	**2.8**	**1.5**
Contribution to GDP growth:	Domestic demand			-0.1	1.1	0.2	-7.9	**6.2**	**2.7**	**1.8**
	Inventories			0.0	0.1	-0.4	-0.3	**0.2**	**0.0**	**0.0**
	Net exports			0.1	-0.3	0.7	-0.8	**0.2**	**-0.2**	**0.0**
Employment				0.0	0.8	0.1	-10.3	**7.5**	**2.4**	**1.8**
Unemployment rate (a)				9.4	10.6	9.9	9.3	**9.5**	**9.5**	**8.9**
Compensation of employees / head				2.0	2.0	1.8	2.8	**-0.9**	**2.5**	**1.3**
Unit labour costs whole economy				2.0	1.8	1.4	1.3	**-0.1**	**2.4**	**1.3**
Saving rate of households (b)				12.5	10.1	10.0	17.4	**14.8**	**11.6**	**10.4**
GDP deflator				1.8	1.1	0.9	1.4	**0.5**	**3.1**	**2.4**
Harmonised index of consumer prices				1.8	1.2	0.6	-0.1	**1.9**	**5.9**	**2.3**
Terms of trade goods				0.0	-1.2	1.6	4.6	**-5.8**	**-6.1**	**1.7**
Trade balance (goods) (c)				1.0	2.6	3.4	4.1	**2.9**	**0.8**	**1.3**
Current-account balance (c)				-0.4	2.5	3.2	3.7	**2.5**	**1.2**	**1.6**
General government balance (c)				-3.1	-2.2	-1.5	-9.6	**-7.2**	**-5.5**	**-4.3**
Structural budget balance (d)				-1.1	-2.4	-2.0	-5.2	**-6.3**	**-5.8**	**-4.8**
General government gross debt (c)				118.4	134.4	134.1	155.3	**150.8**	**147.9**	**146.8**

(a) Eurostat definition. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.