12. ITALY

Stable, modest economic growth ahead

Italy's economy is set to grow by around 1% in both 2017 and 2018, supported by low real interest rates and stronger external demand, while structural weaknesses hinder a stronger recovery. Employment is set to further increase, but at a slower pace than in 2015 and 2016, due to the phasing out of tax incentives for new hires. Higher energy prices are set to drive a pick-up in headline inflation, while core inflation is expected to rise more gradually on the back of moderate wage pressure. Deficit and debt are both set to broadly stabilise as a ratio of GDP.

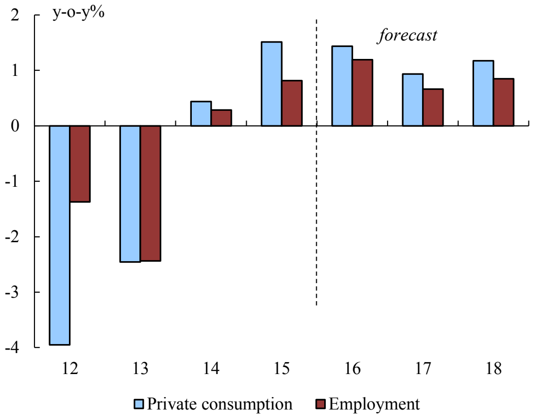
Economic growth seen steady but modest

Real GDP is estimated to have grown by 0.9% in 2016 (up from 0.7% in 2015). Private consumption growth remained sustained thanks to employment growth and low energy prices. Tax incentives and low interest rates boosted equipment investment, while the recovery in construction investment remained sluggish. Exports and imports both slowed substantially, in line with global trade. Financing conditions continued to ease in 2016 and real interest rates on new loans reached historically low levels since the inception of the euro. Credit to the household sector expanded slightly, while SMEs and the construction sector still experience difficulties in access to credit. The bank lending survey for 2016-Q4 points to unchanged credit supply standards and no further improvement is expected for 2017-Q1 as regards firms. Looking forward, the banking sector's low profitability and high burden of NPLs are likely to hold back credit growth.

In 2017, annual real GDP growth is forecast at 0.9%, mainly as a result of supportive monetary policy and expected acceleration in global demand. Private consumption is set to benefit from further, although slower, employment creation. However, higher energy prices affect real disposable income and imply some deceleration in consumption compared to 2016. Investment is set to increase by 2.4%, as it benefits from measures in the 2017 Budget, which extended tax incentives and widened their scope to digital investment, and from the Investment Plan for Europe. Still, persistent structural weaknesses are expected to hamper a stronger recovery of investment. Exports are set to take advantage of stronger external demand. Imports are set to accelerate due to higher domestic demand, particularly for investment.

In 2018, annual real GDP growth is set to continue at a similar pace (1.1%) sustained by both domestic and external demand developments. The current-account surplus is projected to decline from 2.7% of GDP in 2016 to 1.8% in 2018, also due to higher import prices, with the forecast increase in savings more than offset by stronger investment. Political uncertainty and the banking sector's slow adjustment pose downside risks to the growth outlook. Yet, a stronger impulse could still occur from external demand.

Graph II.12.1: **Italy - Private consumption and employment**



The unemployment rate remains elevated

Past reforms, including a permanent reduction in labour taxation, are set to support employment in 2017 and 2018. Yet, net job creation is projected to slow down compared to the 2015-2016 period, when it was boosted by a three-year reduction in social contributions. Over the forecast horizon, employment growth is set to be stronger in terms of working hours than headcount, partly because of diminishing arrangements to reduce working time. This implies, together with higher labour force participation, that the unemployment rate is set to remain above 11% over the forecast horizon. High unemployment and subdued inflation expectations are set to curb labour cost pressure in 2017 and 2018. Recent wage agreements in the metal and other sectors seem to confirm this. Overall, nominal unit labour costs are set to slightly increase in 2017, with some acceleration in 2018 due to expiring tax incentives.

Energy prices drive headline inflation

In 2016, HICP headline inflation was close to zero for the third year in a row due to a further decline in energy prices and moderate core inflation. As energy prices rise, inflation is set to climb to 1.4% in 2017 and stabilise in 2018. On the back of moderate wage developments and further recovery in profit margins, core inflation is expected to gradually increase (from 0.5% in 2016 to 1.2% in 2018).

Broadly stable deficit- and debt-to GDP ratios

The general government deficit is expected to turn out at 2.3% of GDP in 2016, down from 2.6% in 2015, mainly thanks to lower interest expenditure. Current primary expenditure is estimated to have increased by around 1.5% in nominal terms. Revenues remained broadly stable, resulting in a reduction in the tax burden. This was mainly due to the lower labour tax wedge and the abolition of property tax on primary residences.

In 2017, the deficit is set to broadly stabilise to 2.4% of GDP, as current primary expenditure and current revenues are both expected to increase by around 1.5% in nominal terms. The 2017 Budget provided for higher pension expenditure, but past reforms and moderate increases in public wages and healthcare expenditure are set to keep current primary expenditure in check. The budget also supports public investment. In 2017, the tax burden is set to further decline thanks to the reduction in the corporate income tax rate to 24% from 27.5%. The Commission takes positive note of the government's public commitment to adopt additional fiscal measures worth overall 0.2% of GDP by April 2017. These will be taken into account as soon as sufficient details are available to assess the specific provisions to be enacted.

In 2018, under a no-policy-change assumption, the deficit is forecast to increase to 2.6% 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 entrepreneurial income of small firms (IRI).

The government debt-to-GDP ratio is estimated to have increased to 132.8% in 2016 partly due to an increase in the liquidity buffer. A further slight increase is expected also in 2017 partly due to the additional resources earmarked for the public support to the banking sector and retail investors.

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	2018
GDP		1642.4	100.0	0.6	-1.7	0.1	0.7	**0.9**	**0.9**	**1.1**
Private Consumption		1001.8	61.0	0.8	-2.5	0.4	1.5	**1.4**	**0.9**	**1.2**
Public Consumption		311.0	18.9	0.8	-0.3	-0.9	-0.6	**0.6**	**0.2**	**0.4**
Gross fixed capital formation		273.4	16.6	0.3	-6.6	-3.0	1.3	**1.9**	**2.4**	**3.1**
of which: equipment		95.1	5.8	0.7	-8.2	0.9	4.3	**4.8**	**4.6**	**3.7**
Exports (goods and services)		493.7	30.1	2.2	0.7	2.9	4.3	**1.5**	**3.0**	**3.2**
Imports (goods and services)		443.1	27.0	2.7	-2.4	3.3	6.0	**2.1**	**3.9**	**4.3**
GNI (GDP deflator)		1633.3	99.4	0.6	-1.8	0.3	0.2	**1.3**	**0.9**	**1.1**
Contribution to GDP growth:	Domestic demand			0.7	-2.8	-0.4	1.0	**1.3**	**1.0**	**1.3**
	Inventories			0.0	0.2	0.6	0.1	**-0.3**	**0.1**	**0.0**
	Net exports			0.0	0.9	0.0	-0.4	**-0.1**	**-0.1**	**-0.2**
Employment				0.3	-2.4	0.3	0.8	**1.2**	**0.7**	**0.8**
Unemployment rate (a)				8.7	12.1	12.7	11.9	**11.7**	**11.6**	**11.4**
Compensation of employees / f.t.e.				2.5	1.3	-0.2	0.4	**0.0**	**0.8**	**1.5**
Unit labour costs whole economy				2.2	0.6	0.0	0.5	**0.3**	**0.5**	**1.2**
Real unit labour cost				0.0	-0.6	-0.8	-0.2	**-0.6**	**-0.4**	**0.1**
Saving rate of households (b)				13.8	11.0	11.1	10.4	**11.0**	**11.1**	**11.5**
GDP deflator				2.2	1.2	0.9	0.6	**0.9**	**0.9**	**1.1**
Harmonised index of consumer prices				2.3	1.2	0.2	0.1	**-0.1**	**1.4**	**1.3**
Terms of trade goods				-0.6	1.8	3.3	4.0	**2.8**	**-2.1**	**-0.4**
Trade balance (goods) (c)				0.6	2.2	2.9	3.2	**3.5**	**3.0**	**2.7**
Current-account balance (c)				-0.8	1.0	1.9	1.6	**2.7**	**2.1**	**1.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.6	1.0	2.1	1.8	**2.9**	**2.4**	**1.9**
General government balance (c)				-3.2	-2.7	-3.0	-2.6	**-2.3**	**-2.4**	**-2.6**
Cyclically-adjusted budget balance (d)				-3.2	-0.4	-1.0	-1.1	**-1.4**	**-1.9**	**-2.6**
Structural budget balance (d)				-	-0.9	-1.2	-1.0	**-1.6**	**-2.0**	**-2.5**
General government gross debt (c)				107.6	129.0	131.9	132.3	**132.8**	**133.3**	**133.2**

(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.