12. ITALY

Investment-driven recovery is set to continue

Following the acceleration in output growth in 2017, the Italian economy is expected to continue to grow at the same pace of 1.5% this year, largely supported by domestic demand. As support from tailwinds is expected to wane and the output gap closes, GDP growth is set to moderate to 1.2% in 2019. The general government deficit is projected to decrease in 2018 to 1.7% of GDP assuming no further policy changes, while the debt-to-GDP ratio is set to slightly decline below 130% by 2019 on the back of stronger nominal GDP growth.

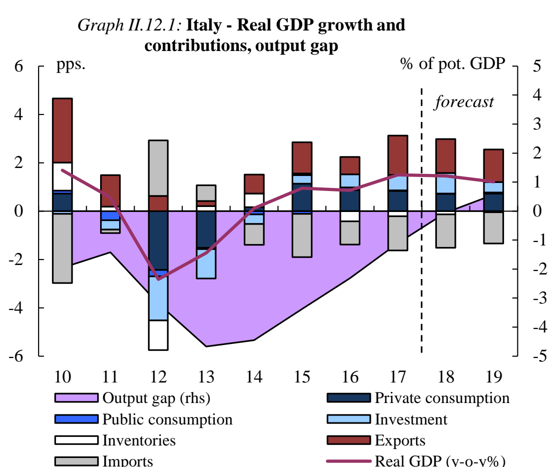
Italy's economic recovery accelerated in 2017

The year 2017 ended on a solid footing, with GDP growth enjoying the support of exports and investment. Overall, Italy's real GDP expanded by 1.5%, driven both by domestic and external demand. However, weak industrial production data in early 2018 and the softening of survey indicators suggest a temporary slowdown in the first quarter of 2018.

Domestic demand is supporting growth

Despite the expected moderation in growth momentum in the first quarter, GDP growth in 2018 is forecast at 1.5%. Household consumption is projected to grow in line with the moderate wage and employment outlook, while tax incentives and favourable financing conditions are set to boost equipment investment.

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



Buoyant business investment is forecast to induce higher imports, while export growth is expected to lose some momentum due to the lagged impact of the euro's appreciation. As a result, net trade is not expected to make a positive contribution to growth in 2018 implying, together with higher prices for energy imports, a lower current account surplus. In 2019, the Italian economy is expected to continue growing above potential but growth is forecast to moderate to 1.2% as global demand becomes less supportive and the output gap closes. Investment growth is set to slow down, partly due to a smaller carry-over effect, whereas private consumption growth is forecast to remain sustained.

Risks to the growth outlook have become more tilted to the downside. Policy uncertainty has become more pronounced and, if prolonged, could make markets more volatile and affect economic sentiment and risk premia. On the upside, the investment-led recovery may spur productivity, and eventually GDP growth, more than expected.

Upward trend in employment continues but unemployment recedes only gradually

Positive labour market trends, which began in 2015, are expected to continue over the forecast period. Employment is projected to grow broadly in line with economic activity but also to benefit from the new permanent three-year reductions of social contributions for hiring newly-employed young workers. Due to higher labour force participation, the unemployment rate is set to fall below 11% in 2018 and to decrease to 10.6% in 2019. Contained wage growth due to the remaining slack in the labour market and moderately increasing productivity are expected to keep the average growth of nominal unit labour costs at about 1% in 2018 and 2019.

Consumer prices increase moderately

In the first quarter of 2018, headline annual HICP inflation slowed to 0.9% from 1.3% in 2017. This deceleration was largely due to negative base effects related to prices for unprocessed food. For the remainder of the year, consumer prices are projected to rise moderately and average 1.2% on the back of higher oil prices. Annual HICP inflation is expected to increase to 1.4% in 2019, mainly driven by the steady rise of prices for non-energy industrial goods and services. Core inflation is set to pick up gradually over the

forecast period – in line with moderate wage growth – and reach 1.4% in 2019.

Stable deficit at unchanged policies

The general government headline deficit slightly declined to 2.3% of GDP in 2017 (from 2.5% in 2016), as rising revenues and contained spending more than compensated for the cost of the support to the banking sector.

In 2018, the headline deficit is expected, assuming no further policy changes, to decline to 1.7% of GDP, supported by economic growth and some measures included in the 2018 budget. Overall, Italy's primary balance is forecast to improve from 1.5% of GDP in 2017 to 1.9% in 2018. Revenues are set to benefit from the positive impact of past provisions aimed at collecting unsettled tax liabilities and fighting tax evasion, as well as from the postponement to 2019 of a tax regime for small enterprises, which was previously legislated for 2018. The temporary reduction of social security contributions is expected to have only a limited negative impact on revenues. The spending review included in the 2018 budget is set to curb government expenditure for intermediate consumption, at both central and local level. On the other hand, the total compensation of employees is expected to rise due to the moderate increase in public wages, which have been frozen since 2010. Although wage increases were agreed already for 2017 in specific sectors, their budgetary impact will only be recorded as from 2018. Overall, Italy's structural balance is expected to remain broadly unchanged, at -1¾% of GDP.

In 2019, the headline deficit is set to remain constant at 1.7% of GDP, under the assumption of unchanged policies and excluding the legislated hike in VAT rates. Revenues are forecast to benefit from the introduction of compulsory electronic invoicing for private sector transactions, while being slightly curbed by other measures like the fiscal incentives for investment. Expenditure growth is expected to slightly accelerate, partly due to small increases in social spending legislated since 2016. The structural balance is estimated to worsen by about ¼ pps. of GDP.

The debt-to-GDP ratio is expected to have peaked in 2017 at 131.8%, also due to public support to the banking sector, and to progressively decline to 130.7% in 2018 and 129.7% in 2019, mainly as a result of stronger nominal GDP growth.

Table II.12.1:

Main features of country forecast - ITALY

	2016		Annual percentage change						
	bn EUR Curr. prices	**% GDP**	**98-13**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
GDP	1680.9	100.0	0.4	0.1	1.0	0.9	**1.5**	**1.5**	**1.2**
Private Consumption	1022.4	60.8	0.4	0.3	1.9	1.4	**1.4**	**1.2**	**1.2**
Public Consumption	316.5	18.8	0.8	-0.7	-0.6	0.6	**0.1**	**0.1**	**0.2**
Gross fixed capital formation	288.1	17.1	-0.2	-2.3	2.1	3.2	**3.8**	**4.8**	**2.4**
of which: equipment	104.4	6.2	-0.1	1.9	4.6	7.4	**8.3**	**9.1**	**3.1**
Exports (goods and services)	500.9	29.8	1.9	2.7	4.4	2.4	**5.4**	**4.5**	**4.2**
Imports (goods and services)	446.3	26.5	2.0	3.2	6.8	3.5	**5.3**	**4.9**	**4.5**
GNI (GDP deflator)	1684.7	100.2	0.4	0.3	0.4	1.6	**1.8**	**1.4**	**1.2**
Contribution to GDP growth: Domestic demand			0.4	-0.4	1.4	1.5	**1.5**	**1.6**	**1.2**
Inventories			0.0	0.6	0.1	-0.4	**-0.2**	**-0.1**	**0.0**
Net exports			0.1	-0.1	-0.5	-0.2	**0.2**	**0.0**	**0.0**
Employment			0.1	0.2	0.7	1.4	**0.8**	**0.8**	**0.7**
Unemployment rate (a)			8.8	12.7	11.9	11.7	**11.2**	**10.8**	**10.6**
Compensation of employees / f.t.e.			2.3	0.0	1.0	0.3	**0.3**	**2.1**	**1.0**
Unit labour costs whole economy			2.1	0.1	0.7	0.8	**-0.4**	**1.5**	**0.5**
Real unit labour cost			0.0	-0.9	-0.3	-0.1	**-1.0**	**0.1**	**-0.8**
Saving rate of households (b)			13.4	11.2	10.6	10.4	**9.7**	**9.7**	**9.9**
GDP deflator			2.1	1.0	0.9	0.8	**0.6**	**1.4**	**1.3**
Harmonised index of consumer prices			2.3	0.2	0.1	-0.1	**1.3**	**1.2**	**1.4**
Terms of trade goods			-0.6	3.5	4.2	3.2	**-1.6**	**0.1**	**0.3**
Trade balance (goods) (c)			0.5	2.9	3.1	3.4	**3.3**	**3.3**	**3.4**
Current-account balance (c)			-0.9	1.9	1.5	2.5	**2.8**	**2.6**	**2.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.8	2.0	1.7	2.3	**2.7**	**2.6**	**2.6**
General government balance (c)			-3.2	-3.0	-2.6	-2.5	**-2.3**	**-1.7**	**-1.7**
Cyclically-adjusted budget balance (d)			-3.1	-0.6	-0.7	-1.2	**-1.7**	**-1.6**	**-2.0**
Structural budget balance (d)			-3.7	-0.8	-0.6	-1.4	**-1.7**	**-1.7**	**-2.0**
General government gross debt (c)			108.5	131.8	131.5	132.0	**131.8**	**130.7**	**129.7**

(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.