11. ITALY
Slow recovery continues

A moderate recovery under way

Italy is experiencing a moderate recovery after the severe output loss recorded during the 2008-09 crisis. Over the forecast horizon, real GDP is not expected to accelerate as long-standing structural weaknesses are set to continue weighing on Italy's economic growth prospects.

In 2010 as a whole, real GDP expanded by 1.3%. In quarterly terms, real GDP growth reached 0.5% in the first two quarters and then eased to 0.3% and 0.1% in the two subsequent quarters.

A strong expansion of external demand, particularly in the first half of the year, generated a rebound in export volumes, which led the recovery. Together with tax incentives that expired in June, external demand also supported investment in equipment. But investment in construction continued to decline in 2010 due to the protracted weakness of the property market and a strong contraction in government capital spending.

Exports of goods grew significantly faster than exports of services. However, driven by the upturn in investment in equipment and the significant upswing in stockbuilding, merchandise imports, especially of intermediate goods, outpaced exports. As a result, net exports provided a negative contribution to real GDP growth in 2010.

Despite improved financial market conditions, private consumption dynamics were muted throughout 2010 also due to a still-fragile labour-market situation. While overall private consumption rose compared to 2009, expenditure on durable goods, which until the end of 2009 had benefited from tax incentives to buy energy-efficient goods, declined.

Exports to be the main growth driver also in 2011-12

Real GDP is expected to grow by 1.0% in 2011 and 1.3% in 2012, around ½ pp. below the euro-area average in each year. In quarterly terms, real GDP growth is forecast to be modest in the first quarter of 2011 and accelerate thereafter, to around 0.3-0.4% q-o-q until the end of 2012.

Supported by sustained external demand, exports are set to continue driving the recovery in 2011-12. Although there is evidence of a gradual shift in their geographical orientation towards fast-growing emerging markets, Italian exports are still mainly dependent on demand prospects in euro-area partners. Export growth rates are thus set to remain below those of global demand. As imports are forecast to grow slightly less than exports in 2011-12, on the back of slow domestic demand dynamics, net exports are projected to make a small positive contribution to real GDP growth in both years.

External demand is expected to continue supporting investment in equipment, which will also benefit from improved profitability. At the same time, however, still low levels of capacity utilisation in industry and the need for further balance-sheet adjustment, notably within small and medium-sized enterprises, will limit the scope for new investment.

Investment in construction is projected to continue contracting in 2011 and return to modest positive growth only in 2012. While investment in residential building is expected to pick up as housing market conditions improve, government investment spending is set to continue declining over the forecast horizon as part of the budgetary consolidation strategy.

Private consumption growth is forecast to remain moderate in 2011-12, as labour market conditions are expected to improve only gradually and higher inflationary pressures are set to dampen the increase in real disposable income.

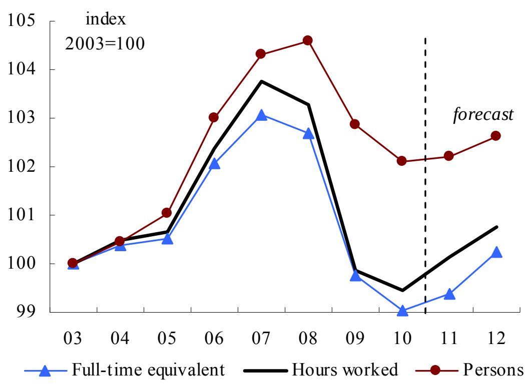
Risks to the outlook for the Italian economy appear somewhat tilted to the downside. In particular, inflation could prove higher than anticipated due to the effects of the ongoing geopolitical tensions in the MENA region on energy prices, with negative spillovers mainly on private consumption. Moreover, a more marked rise in interest rates than currently assumed by financial markets could adversely affect firms' investment decisions.

A mild recovery in headcount employment

In 2010, employment declined further, although by less than in 2009. Over 2009-10, the negative impact of the crisis was more pronounced on full-time equivalent than on headcount employment (in cumulative terms -3.6% as against -2.3%) because firms chose to hoard labour through the wage supplementation scheme (CIG), whereby employees stop working or reduce hours worked but keep their job at reduced pay. Throughout the crisis, requests to access this scheme rose steadily. However, the composition shifted from ordinary CIG benefits to special ones under an extended CIG scheme covering longer inactivity spells and workers otherwise ineligible by reason of sector, firm size or type of employment contract.

Over the forecast horizon, firms – in particular in manufacturing – are expected to reabsorb employees benefiting from the CIG scheme before starting to hire new workers. Therefore, the gradual recovery in output is assumed to translate first into an expansion of hours worked and only at a later stage in additional headcount employment, which is set to start rising marginally in 2011 and accelerate somewhat in 2012.

Graph II.11.1: **Italy - Employment developments**



Reflecting the moderate decline in headcount employment and a shrinking labour supply in response to depressed labour market conditions, the unemployment rate increased only gradually over 2009-10, stabilising at around 8½% at the end of 2010. However, the youth unemployment rate rose by more than 6 pps. over the same period, exceeding 28% in the first months of 2011. Also long-term unemployment[77] as a share of total unemployment soared by over 4 pps. in 2010, to 48.5%. Over the forecast period, the total unemployment rate is set to remain above 8% on account of the modest recovery in headcount employment.

[77] People having sought a job for more than 12 months.

As in 2009 the contraction in real GDP was much sharper than the fall in employment, the decline in labour productivity already under way since 2008 intensified. In 2010 further job losses, together with the moderate GDP recovery, implied a rebound in productivity. As labour market conditions are expected to improve slowly, productivity is forecast to rise mildly in 2011-12, in line with its pre-crisis trend.

Beyond the increases in contractual wages in line with projected HICP inflation excluding imported energy, as foreseen in the reformed wage-bargaining framework, weak labour-market conditions and productivity developments are poised to leave little scope for additional wage increases at the level of firms or sectors. As a result, after remaining broadly constant in 2010, unit labour costs are expected to increase only moderately in 2011-12. The projected evolution of unit labour costs over the forecast horizon, however, would not be sufficient to allow Italy to regain competitiveness vis-à-vis the rest of the euro area.

Energy prices drive inflation up in 2011

After a sizeable decline in 2009, HICP inflation increased to 1.6% on average in 2010. The acceleration of prices in the last quarter of 2010 was mainly due to the dynamics of the energy component, amplified by a low base effect from 2009.

In 2011, mainly due to significantly higher energy prices, inflation is expected to continue increasing in the first half of the year and reach 2.6% on average, in line with the euro-area average. No major second-round effects from higher commodity prices are expected, thanks to still-weak demand and the inflation benchmark of the reformed wage-bargaining framework. As a consequence, core inflation is set to rise more mildly (1.8%, up from 1.5% in 2010). In 2012, as oil prices are expected to stabilise, the energy component of the HICP is set to decelerate significantly and both headline and core inflation are forecast at 1.9%.

As the Italian economy is highly dependent on imported energy, the marked rise in import prices worsened the terms of trade and led to a significant deterioration in the trade balance and thus in the external deficit in 2010. According to national accounts data, the external deficit reached around

3% of GDP in 2009 and 4¼% in 2010. According to recent balance-of-payments figures calculated by the Bank of Italy, the external deficit is estimated to be around ¾% of GDP lower in both years, due to a smaller deficit in the balance of primary income. External balance projections for 2011-12 incorporate the revised primary income statistics.[78] Over the forecast horizon, the external deficit is forecast to remain between 3¼% and 3½% of GDP.

Fiscal consolidation gains traction

After deteriorating in 2008-09 largely due to the effect of automatic stabilisers, the situation of Italy's public finances improved in 2010. The general government deficit narrowed to 4.6% of GDP in 2010, from 5.4% in 2009, mainly thanks to a decline in expenditure, and the primary balance remained only marginally negative.

Consolidation measures adopted in previous years helped to curb capital and current spending in 2010. As a share of GDP, current primary expenditure decreased by over 1 pp. Regarding the wage bill, very moderate increases in contractual public wages were granted, although some arrears were paid, while constraints to recruitment brought about a decline in payroll numbers. Government consumption for health services was kept in check also by measures to reduce the cost of pharmaceutical products. Social transfers rose only marginally as a share of GDP since pension expenditure reflected indexation to a subdued 2009 inflation rate, while transfers to the unemployed remained elevated, in particular due to those granted on an ad hoc basis through the extension of the CIG scheme. Interest expenditure fell further (to 4.5% of GDP) due to historically low short-term interest rates. Capital spending declined substantially in 2010 given the temporary impact of some recovery measures adopted in 2009. As a result, total expenditure fell by around 0.5% y-o-y and 1¼ pps. of GDP, to 50.6%.

Revenues declined by around ½ pp. of GDP in 2010, to 46.0%. Capital taxes were more than halved in 2010, mostly due to the scaling back of one-off measures. By contrast, current tax revenues rose by around ¼ pp. of GDP thanks to the recovery in indirect taxes, also supported by the larger-than-anticipated proceeds of a measure adopted in 2009 that prohibits the offsetting of tax dues with unaudited tax credits above EUR 15 000. Direct taxes were broadly flat in terms of GDP, with positive developments in personal income taxes – also boosted by a deferred tax payment from 2009 – and some recovery in corporate taxes. In contrast, withholding taxes paid by households on bank deposit interests plunged.

The deficit is expected to continue declining over the forecast horizon, by around ½ pp. of GDP in 2011 and a further ¾ pp. in 2012. This outlook incorporates the multi-annual consolidation packages covering 2011 and 2012 in place, but with a more cautious assessment of the effectiveness of some of the measures to combat tax evasion and a smaller decline in capital expenditure.

In 2011, current primary expenditure is again set to grow less than nominal GDP. The ½ pp. of GDP fall from 2010 is almost entirely due to compensation of employees, which is affected by a freeze of nominal wages to their 2010 levels, accompanied by further restrictions on recruitment. Intermediate consumption is set to grow modestly in 2011, as strict limits on transfers to regional and local governments are assumed to curtail their purchases of goods and services. Social transfers are expected to increase in line with nominal GDP growth, as access to retirement has been postponed by several months while outlays related to the weak labour market are set to decrease. Capital spending is expected to drop by almost ½ pp. of GDP, with half of this fall explained by the planned sale of broadband licences, recorded as one-off disposal of government assets. Interest expenditure is anticipated to start growing again as a share of GDP. Overall, total expenditure is set to decline to around 50% of GDP in 2011.

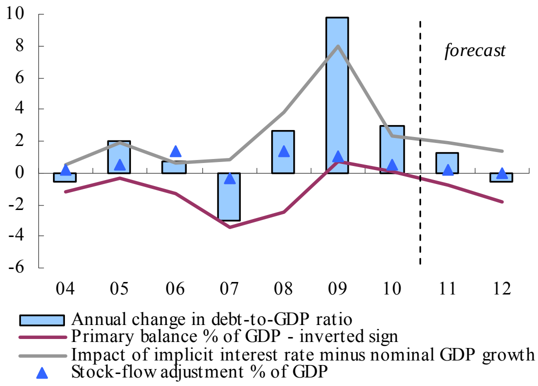
Revenues from current taxes are projected to increase broadly in line with nominal GDP in 2011, essentially thanks to indirect tax proceeds, while direct taxes are negatively affected by the postponement of some personal income tax payments to 2012. Capital revenues are expected to continue falling, mainly due to fading one-off capital tax proceeds. Total revenues are set to remain stable as a share of GDP.

As a result, the primary balance is projected to return to surplus in 2011, at around ¾% of GDP, whereas the headline deficit is expected to decrease to 4% of GDP. In 2012, the deficit is set

(78) This creates a break in the series in 2011. The balance of payments figures are expected to be incorporated in revised national accounts data later in 2011.

to decline further, to 3.2% of GDP, and the primary surplus to expand to almost 2% of GDP. After improving by ¾ pp. of GDP in 2010, the structural deficit is expected to narrow by about the same amount over the rest of the forecast horizon.

Graph II.11.2: **Italy - Drivers of debt developments**



In 2012, current primary expenditure is projected to increase by 1¼% relative to 2011, resulting in a drop of ¾ pp. of GDP. Compensation of employees is set to remain constant in nominal terms, while intermediate consumption is assumed to continue increasing at a moderate pace. Capital spending is expected to be held back mainly by the protracted restraint in local spending. Interest expenditure is set to increase further, to 5.1% of GDP.

Current revenues are expected to rise slightly more than nominal GDP in 2012, thanks in part to the above-mentioned postponement of personal income tax payments, whereas capital revenues are set to recover some of the previous years' losses.

Gross government debt as a share of GDP rose by a further 3 pps. in 2010, to 119%. The impact of the difference between the implicit interest rate paid on debt and nominal GDP growth – the so-called snowball effect – was the main contributor, together with the further accumulation of liquidity held by the Treasury with the Bank of Italy and loans to Greece, affecting the stock-flow adjustment. The debt ratio is set to peak at around 120¼% of GDP in 2011 and then decline thanks to the increasing primary surplus.

Table II.11.1:
Main features of country forecast - ITALY

	2009		Annual percentage change						
	bn EUR Curr. prices	**% GDP**	**92-06**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
GDP	1519,7	100,0	1,4	1,5	-1,3	-5,2	**1,3**	**1,0**	**1,3**
Private consumption	912,3	60,0	1,3	1,1	-0,8	-1,8	**1,0**	**0,6**	**1,1**
Public consumption	326,2	21,5	0,8	0,9	0,5	1,0	**-0,6**	**-0,4**	**0,1**
Gross fixed capital formation	289,7	19,1	1,5	1,7	-3,8	-11,9	**2,5**	**2,2**	**3,1**
of which : equipment	121,2	8,0	2,2	3,1	-5,0	-16,3	**10,5**	**5,1**	**4,7**
Exports (goods and services)	362,4	23,8	4,4	4,6	-4,3	-18,4	**9,1**	**6,0**	**5,7**
Imports (goods and services)	368,7	24,3	3,9	3,8	-4,4	-13,7	**10,5**	**4,6**	**5,1**
GNI (GDP deflator)	1496,9	98,5	1,5	1,0	-2,2	-5,2	**1,5**	**1,7**	**1,3**
Contribution to GDP growth : Domestic demand			1,2	1,2	-1,2	-3,3	**0,9**	**0,7**	**1,3**
Inventories			0,1	0,1	-0,2	-0,6	**0,7**	**-0,1**	**-0,1**
Net exports			0,1	0,2	0,0	-1,3	**-0,4**	**0,3**	**0,1**
Employment			0,3	1,0	-0,4	-2,6	**-0,7**	**0,4**	**0,9**
Unemployment rate (a)			9,6	6,1	6,7	7,8	**8,4**	**8,4**	**8,2**
Compensation of employees/f.t.e.			3,3	2,4	3,8	1,5	**2,0**	**1,5**	**1,8**
Unit labour costs whole economy			2,3	1,9	4,8	4,3	**0,0**	**0,9**	**1,3**
Real unit labour costs			-0,8	-0,7	2,0	2,0	**-0,6**	**-0,7**	**-0,5**
Savings rate of households (b)			18,6	14,8	15,2	14,9	**13,4**	**13,2**	**13,1**
GDP deflator			3,1	2,6	2,8	2,3	**0,6**	**1,6**	**1,8**
Harmonised index of consumer prices			3,0	2,0	3,5	0,8	**1,6**	**2,6**	**1,9**
Terms of trade of goods			-0,4	1,5	-2,9	8,0	**-3,0**	**-1,9**	**0,5**
Trade balance (c)			1,7	0,2	-0,1	0,1	**-1,3**	**-1,5**	**-1,3**
Current-account balance (c) (d)			0,4	-1,8	-3,2	-3,0	**-4,2**	**-3,5**	**-3,3**
Net lending(+) or borrowing(-) vis-à-vis ROW (c) (d)			0,5	-1,7	-3,2	-2,9	**-4,2**	**-3,5**	**-3,2**
General government balance (c)			-4,7	-1,5	-2,7	-5,4	**-4,6**	**-4,0**	**-3,2**
Cyclically-adjusted budget balance (c)			-4,9	-3,0	-3,2	-3,2	**-2,9**	**-2,6**	**-2,2**
Structural budget balance (c)			-	-3,1	-3,4	-3,9	**-3,1**	**-2,7**	**-2,3**
General government gross debt (c)			111,8	103,6	106,3	116,1	**119,0**	**120,3**	**119,8**

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
(d) Break in the series in 2011 as the forecast incorporates the recent revision of Italy's balance of payments made by the Bank of Italy that is not yet reflected in historical National Account data.