12. ITALY

Exports and investment in equipment support a slow recovery

After a severe recession in 2012 and 2013, a slow recovery mainly driven by external demand is projected in 2014. With credit conditions set to ease over the forecast horizon, growth is expected to strengthen in 2015. Inflation is set to reach a historical low in 2014 amid weak labour cost pressures and declining energy prices. The government balances adjusted for the business cycle and one-offs are expected to broadly stabilise over 2013-15.

A slow recovery supported by exports

Real GDP contracted by 1.9% in 2013, albeit signs of output stabilisation emerged from the second half of the year. The uptick in the fourth quarter stemmed from the positive performance of exports and an increase in investment in equipment. This pattern is set to strengthen over the course of 2014 as external demand increases. In particular, firms' capacity utilisation is projected to increase as exports rise, encouraging new investment in equipment. At the same time, investment in construction is expected to contract further as protracted tight financing conditions delay recovery. Confidence – both for consumers and industry – has been improving since mid-2013. Households are set to raise their consumption while restoring savings, also thanks to the cut to the labour tax wedge.

Following the ongoing bank balance-sheet adjustments and the eventual pass-through of lower sovereign interest rates to the private sector, more favourable credit conditions are forecast to support the recovery and strengthen investment from the end of 2014. This is expected to pave the way for a firmer economic recovery in 2015, supported again by increasing exports but also domestic demand, including investment in construction. As the projected acceleration in domestic demand entails an uptake in imports, the resulting current-account surplus is projected to stabilise at around 1.5% of GDP in 2015.

Downside risks to Italy's economic outlook could stem from a further appreciation of the euro and geopolitical tensions, both of which would damage the expected export-driven recovery.

### Weak labour market conditions

The large contraction in economic activity in 2013 continues to weigh on headcount employment, which is projected to further decline in 2014, before gradually resuming over the forecast horizon. The labour force is set to increase on the back of discouraged workers re-entering the labour market as the recovery sets in. Accordingly, the unemployment rate is projected to peak in 2014, at 12.8%, and then marginally decline in 2015. Over 2014-15, labour productivity growth is set to recover somewhat, while remaining below the euro-area average. This, combined with a projected moderate wage growth, entails decelerating unit labour costs over the forecast horizon, broadly in line with the rest of the euro area.

Inflation is set to reach historical lows

HICP inflation, which has been slowing down since the second half of 2012 owing to falling domestic demand and decelerating energy prices, is forecast to reach a historical low in 2014, at 0.7%, before resuming to 1.2% in 2015, on the back of increasing import prices. Weak labour cost pressures are expected to keep core HICP inflation just above 1% in both 2014 and 2015.

Graph II.12.1: **Italy and euro area- Unit Labour Cost and core inflation (3-year moving average)**
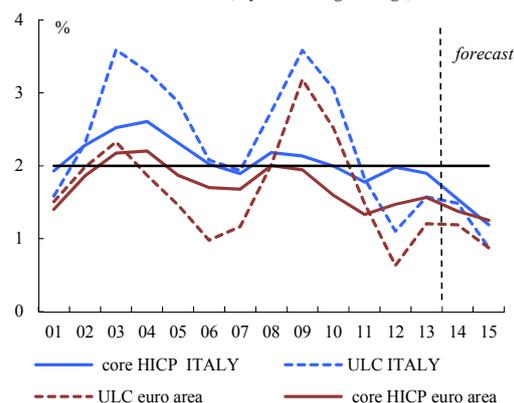
### The government structural balances stabilise

In 2013, the general government deficit remained 3% of GDP. Declining sovereign-bond yields led to a decrease in interest expenditure, offsetting the decline in the primary surplus. Primary expenditure marginally increased by 0.3% y-o-y driven by higher current expenditure, while capital expenditure fell significantly despite the settlement

of overdue trade debt. The latter had an impact on investment (and deficit) estimated at around 0.4% of GDP. Revenues diminished in line with nominal GDP, mainly due to a fall in VAT, personal income and property taxes.

In 2014, the headline deficit is projected to decline to 2.6% of GDP. Interest expenditure is expected to decrease further as a share of GDP and the primary surplus to increase to 2.6% of GDP. The moderate year-on-year increase in primary expenditure is mainly driven by social transfers, while the recently adopted savings are set to curb intermediate consumption. The tax burden is forecast to decrease by 0.2 pp. of GDP mainly due to the tax wedge cut adopted for 2014, which is partly offset by new one-off taxes to finance it. In 2015, the deficit is forecast to narrow further to 2.2% of GDP as the primary surplus reaches 2.9% of GDP, mainly owing to higher growth. In line with the customary no-policy-change assumption, the announced tax cut to low-income employees and spending review measures are not incorporated in the 2015 forecast as details have not been fully specified yet.

The structural balance is set to improve only marginally and, on a no-policy-change basis, to

remain negative in 2015 (-0.7% of GDP). Over 2013-15, the structural primary balance is projected to stabilise at around 4.4% of GDP.

Graph II.12.2: **Italy - Structural primary balance and determinants (% of GDP)**
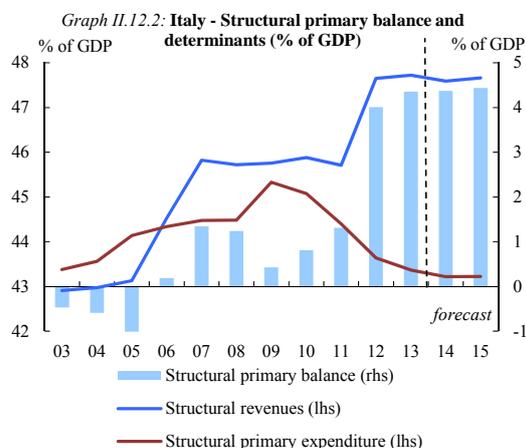
After incorporating additional 2.1% of GDP trade debt arrear settlements (after 1.4% in 2013), the general government debt-to-GDP ratio is expected to peak at around 135% in 2014. It is then projected to decline in 2015 mainly thanks to the higher primary surplus and nominal GDP growth as well as the use of the proceeds of privatisations scheduled in the second half of 2014.

Table II.12.1:

Main features of country forecast - ITALY

		2012			Annual percentage change					
	bn EUR	Curr. prices	% GDP	94-09	2010	2011	2012	2013	2014	2015
GDP		1566.9	100.0	1.0	1.7	0.4	-2.4	-1.9	0.6	1.2
Private Consumption		954.7	60.9	1.2	1.5	-0.3	-4.0	-2.6	0.4	0.8
Public Consumption		313.3	20.0	1.0	-0.4	-1.3	-2.6	-0.8	-0.7	-0.7
Gross fixed capital formation		281.5	18.0	1.4	0.6	-2.2	-8.0	-4.7	1.6	4.0
of which: equipment		114.1	7.3	2.1	8.1	-0.7	-11.0	-2.5	5.9	5.7
Exports (goods and services)		473.9	30.2	2.5	11.4	6.2	2.1	0.1	3.3	4.3
Imports (goods and services)		457.2	29.2	3.5	12.6	0.8	-7.0	-2.8	2.7	4.8
GNI (GDP deflator)		1559.1	99.5	1.1	1.7	0.3	-2.3	-2.0	0.7	1.2
Contribution to GDP growth:	Domestic demand			1.2	0.9	-0.9	-4.5	-2.6	0.4	1.3
	Inventories			0.0	1.1	-0.1	-0.6	-0.1	0.0	-0.1
	Net exports			-0.1	-0.4	1.4	2.7	0.8	0.2	0.0
Employment				0.4	-1.1	0.1	-1.1	-1.9	0.1	0.4
Unemployment rate (a)				9.1	8.4	8.4	10.7	12.2	12.8	12.5
Compensation of employees / f.t.e.				2.9	2.8	1.3	1.0	1.4	1.1	1.3
Unit labour costs whole economy				2.3	0.0	1.0	2.4	1.4	0.7	0.6
Real unit labour cost				-0.4	-0.4	-0.4	0.8	-0.1	-0.2	-0.7
Saving rate of households (b)				17.3	12.4	11.9	11.6	12.9	13.8	13.8
GDP deflator				2.8	0.4	1.4	1.6	1.4	0.9	1.3
Harmonised index of consumer prices				2.6	1.6	2.9	3.3	1.3	0.7	1.2
Terms of trade goods				-0.2	-3.9	-3.6	-1.0	2.0	1.3	-0.1
Trade balance (c)				1.4	-1.3	-1.1	1.1	2.4	3.0	3.0
Current-account balance (c)				0.1	-3.5	-3.1	-0.4	0.9	1.5	1.5
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				0.3	-3.5	-3.0	-0.2	0.9	1.5	1.5
General government balance (c)				-3.9	-4.5	-3.7	-3.0	-3.0	-2.6	-2.2
Cyclically-adjusted budget balance (c)				-4.4	-3.6	-3.0	-1.4	-0.7	-0.7	-0.9
Structural budget balance (c)				-	-3.8	-3.7	-1.5	-0.9	-0.8	-0.7
General government gross debt (c)				111.0	119.3	120.7	127.0	132.6	135.2	133.9

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