

11. ITALY

Manufacturing hit hard by collapse in global demand

The recession deepened in late 2008

Real GDP fell by 1% in 2008, dragged down by both domestic and external demand. The economic downturn had been under way since the spring, initially driven by accelerating prices, growing uncertainty and risk aversion. When inflation started its rapid descent towards the end of 2008, the collapse in global trade took over as the key driver of the contraction in economic activity. The recession deepened in the last quarter of 2008, affecting all components of demand. On the supply side, the fall in real GDP in 2008 was driven by the progressive decline in manufacturing output growth: having already started to weaken in 2007, industrial production plummeted in the last quarter of the year. For 2008 as a whole, the decrease of value added in this sector, at 3%, largely outpaced that for the whole economy.

Economic activity to contract sharply in 2009

The outlook for the first half of 2009 is strongly unfavourable. Short-term indicators point to a protracted retrenchment of economic activity. In particular, industrial output contracted sharply in the first two months and is expected to have fallen again in March. Available soft indicators, however, point to some stabilisation in the coming months. Consumer confidence improved in April and there is evidence of a positive impact of the incentives for the purchase of energy-efficient vehicles. Industrial confidence also recovered in April from the trough recorded in March.

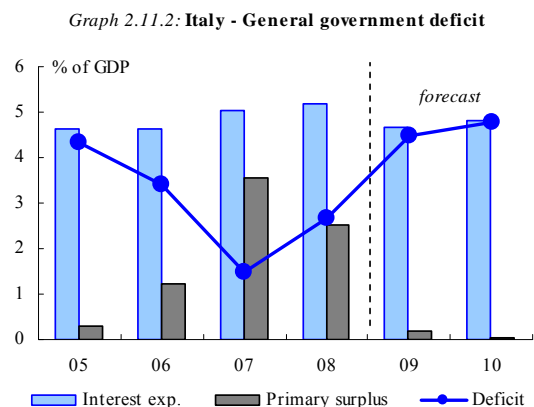
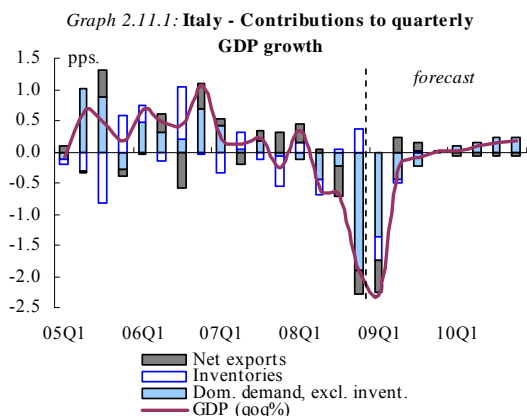
Against this background, real GDP is expected to record another strong contraction in the first

quarter of 2009 and to continue declining throughout most of the year, though gradually moving towards stabilisation. With a significantly negative growth impulse from 2008, in 2009 real GDP is projected to record the strongest annual fall in several decades.

The support to household purchasing power from lower inflation is not likely to prevent private consumption from falling again in 2009, in view of worsening employment prospects and negative wealth effects. This will entail a further rise in the household savings rate. The drop in private fixed investment is forecast to be sharp and protracted, on the back of the uncertainty over the timing of the recovery, reduced capacity utilisation, lower profitability and tighter lending conditions. The contraction in residential investment is also reflected in stagnating mortgage lending. The expected acceleration in public investment is the only positive element in the outlook for gross fixed capital formation in 2009.

The collapse of Italy's export markets is weighing heavily on its external performance. Substantially weaker import demand is unlikely to fully offset the export drag on the economy, translating into a negative contribution of net exports to growth. However, lower commodity prices should allow the trade balance to improve.

In 2010, economic activity is projected to stabilise at a low level. This is due to both domestic and external demand. On the domestic side, private consumption is projected to return to mildly positive growth, while investment should take longer to recover. Exports are expected to



gradually regain some strength on the back of the assumed moderate improvement of the global environment.

Economic downturn hitting the labour market with a lag

The impact of the economic downturn on the labour market has so far been more visible in terms of hours worked than of headcount employment. In spite of declining economic activity, employment still rose in the first three quarters of 2008, particularly in the services sector. It started to fall only in the last quarter. Job losses are expected to build up in 2009, hitting the industrial sector most, and to continue in 2010, although with less intensity. The unemployment rate began to rise in 2008 as new jobseekers, many of them women and new or newly recorded immigrants, outnumbered new hires. The employment decline projected for 2009 and 2010 will result in further increases in the unemployment rate.

Labour productivity decreased substantially in 2008 and is forecast to decline further in 2009, although a turnaround is expected in 2010. The wage agreements signed in 2007-2008 in most sectors of the economy, both private and public, lie behind the marked acceleration in compensation per employee in 2008 and the still-resilient growth in contractual wages already in place for 2009. However, negative wage drift is likely to produce a moderation in overall labour cost growth in 2009. Rising unemployment should contain wage dynamics in 2010.

Combined with negative labour productivity growth, positive wage growth in 2008 gave rise to a sharp acceleration in unit labour costs. The latter are expected to moderate significantly only in 2010. Subdued demand, sluggish productivity growth and lower prices are adversely affecting profitability of corporations: after decelerating in 2008, the gross operating surplus is expected to contract sharply in 2009 and to improve somewhat in 2010 as the economy recovers and growth in labour costs eases.

Inflation drops to historically low levels

In 2009, headline inflation is expected to fall to an unprecedented 0.8%. The energy component of the HICP index is set to continue declining, but energy prices are assumed to recover momentum in 2010. The substantial rise in unit labour costs should

continue to affect core inflation in 2009, which is therefore anticipated to remain more dynamic than headline inflation. In 2010, the two measures of inflation should converge to a level still below 2%.

Recession pushes deficit above 3% of GDP

In 2008, the government deficit increased to 2.7% of GDP, from 1.5% in 2007. The revenue ratio fell by nearly ½ of a percentage point of GDP as the still healthy growth of direct taxes and social contributions, supported by the considerable rise in employment and wages, was offset by the substantial fall of indirect taxes, which was also due to discretionary measures. The primary expenditure-to-GDP ratio increased. Discretionary measures, including a sizeable increase in compensation of employees, resulted in a 4½% rise in current primary expenditure, whereas capital expenditure dropped.

The higher headline deficit in 2008 than in 2007 implied a worsening in the structural balance, i.e. the balance excluding the effects of the cycle and one-offs, thus undoing some of the substantial structural improvement achieved over 2006-2007 to correct the excessive deficit.

The forecast for 2009 and 2010 incorporates the impact of both the three-year fiscal consolidation package approved by Parliament last summer and the measures adopted so far as a response to the economic downturn in the context of the European Economic Recovery Plan.

For the current year, the relative soundness of the banking system and the prudent fiscal response by the government to the downturn have so far contained the negative impact of the crisis on the public finances. Over 2009 as a whole, the headline deficit is forecast to increase to 4½% of GDP. The significant reduction in interest expenditure, thanks to lower short-term interest rates, will only partly offset the erosion of the primary surplus linked to the working of the automatic stabilisers.

Revenues are set to decline in response to the downturn. Direct taxes paid by corporations will be hardest hit because of falling profits, despite some revenue-increasing discretionary measures – namely, the so-called "Robin Hood tax" on banks, insurance companies and firms in the energy sector and one-off taxes to finance the recovery package. Social contributions should decrease in line with

the reduction in the overall wage bill. Indirect taxes are expected to decline by more than nominal consumption, in particular due to a further shift away from more tax-intensive durable goods consumption. Moving in the opposite direction, personal income taxes should increase marginally relative to 2008, also on the back of dynamic pension growth as a result of indexation to the high inflation recorded in 2008. The fact that the downturn is driven by relatively less tax-rich components, such as exports and investment, together with the impact of the above-mentioned discretionary measures, implies that the decline in nominal GDP will outpace that of revenues, resulting in an increasing revenue-to-GDP ratio.

The primary expenditure ratio is forecast to increase by around 3 percentage points of GDP relative to 2008, as a result of declining nominal GDP combined with significant spending increases. The one-off income support to poor households adopted with the recovery package, together with the budgeted spending, will entail a 3½% annual rise in current primary expenditure. In addition, the announced acceleration in public investment, the repurchase of some previously securitized real estate and the recent incentives for energy-efficient durable goods are expected to generate a significant annual increase in capital

expenditure.

In structural terms, the 2009 government balance should improve by around ¾ of a percentage point of GDP, also thanks to lower interest expenditure.

In 2010, under the usual no-policy-change assumption and in a context of very moderate economic growth, the planned expenditure control at all levels of government, if fully implemented, would limit the reduction in the primary balance. The latter will still be affected by an additional fall in taxes paid by corporations. The expected higher servicing cost of public debt will contribute to a further increase in the overall deficit to around 4¾% of GDP. The structural balance is set to slightly worsen relative to 2009.

The projected lower nominal GDP and eroded primary surplus will weigh on the government debt ratio, which is forecast to increase to around 116% of GDP by 2010, a level similar to that recorded at the end of the 1990s. Depending on the extent of banks' recourse to the available recapitalisation scheme, the gross debt ratio could increase further, by up to 1 percentage point of GDP.

Table 2.11.1:

Main features of country forecast - ITALY

	2007		Annual percentage change							
	bn Euro	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	1544.9	100.0		1.4	0.7	2.0	1.6	-1.0	-4.4	0.1
Private consumption	907.6	58.7		1.3	1.2	1.3	1.2	-0.9	-1.7	0.2
Public consumption	304.4	19.7		0.8	1.9	0.5	1.0	0.6	0.7	0.6
Gross fixed capital formation	327.7	21.2		1.5	0.8	2.9	2.0	-3.0	-12.3	-0.6
of which : equipment	145.8	9.4		2.0	1.7	5.1	3.0	-4.6	-17.8	0.3
Exports (goods and services)	448.2	29.0		4.6	1.1	6.2	4.6	-3.7	-15.6	0.1
Imports (goods and services)	451.8	29.2		3.9	2.1	5.9	3.8	-4.5	-12.8	0.2
GNI at previous year prices (GDP deflator)	1535.2	99.4		1.5	0.9	2.2	1.1	-1.9	-4.5	0.1
Contribution to GDP growth :										
Domestic demand				1.2	1.2	1.5	1.3	-1.0	-3.4	0.2
Stockbuilding				0.0	-0.3	0.5	0.0	-0.3	-0.2	0.0
Foreign balance				0.2	-0.2	0.1	0.2	0.3	-0.7	0.0
Employment				0.2	0.2	1.5	1.0	-0.1	-3.3	-0.6
Unemployment rate (a)				10.0	7.7	6.8	6.1	6.8	8.8	9.4
Compensation of employees/f.t.e.				3.4	3.2	2.7	2.2	3.3	2.1	1.5
Unit labour costs whole economy				2.2	2.7	2.2	1.5	4.2	3.3	0.8
Real unit labour costs				-1.0	0.6	0.3	-0.8	1.4	1.3	-0.8
Savings rate of households (b)				-	-	14.8	14.2	14.7	15.1	15.1
GDP deflator				3.3	2.1	1.8	2.4	2.8	1.9	1.5
Harmonised index of consumer prices				3.2	2.2	2.2	2.0	3.5	0.8	1.8
Terms of trade of goods				0.0	-2.3	-3.4	1.5	-2.6	7.5	-0.4
Trade balance (c)				2.0	0.0	-0.7	0.2	0.0	0.9	0.8
Current account balance (c)				0.7	-1.2	-2.0	-1.8	-3.0	-2.6	-2.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.8	-1.1	-1.9	-1.6	-2.9	-2.4	-2.4
General government balance (c)				-4.8	-4.3	-3.3	-1.5	-2.7	-4.5	-4.8
Cyclically-adjusted budget balance (c)				-4.6	-4.6	-4.3	-2.8	-3.2	-2.6	-2.7
Structural budget balance (c)				-	-5.2	-3.9	-2.9	-3.4	-2.6	-2.8
General government gross debt (c)				112.6	105.8	106.5	103.5	105.8	113.0	116.1

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