

## ITALY

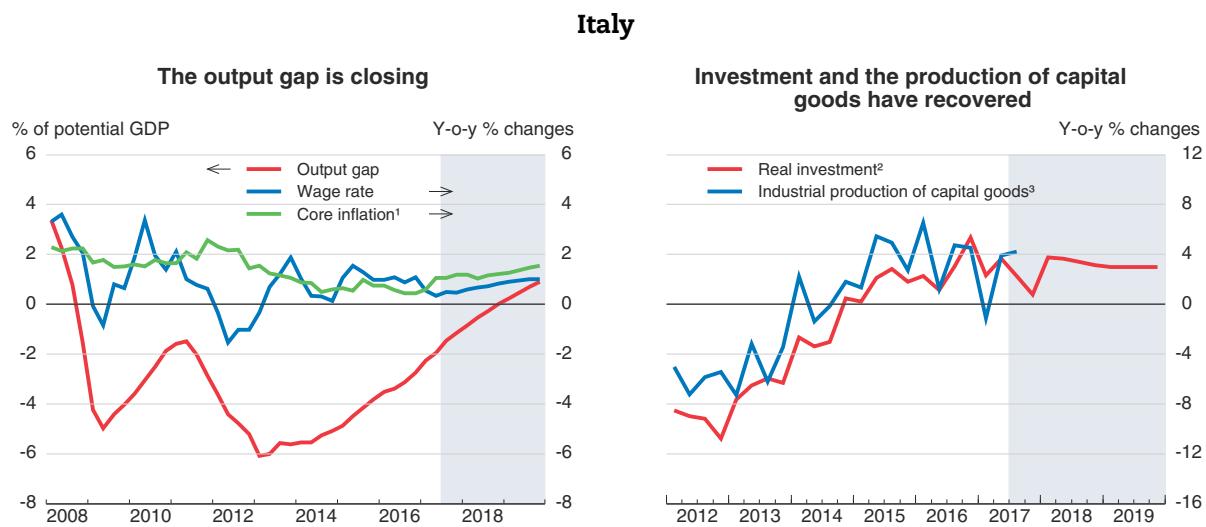
GDP growth is projected to edge down to 1.5% in 2018 and 1.3% in 2019. Private consumption will continue to be the main driver of the recovery, which will continue to broaden to investment and exports. Employment gains will buttress household disposable income. Tax incentives and rising external demand will support business investment and export growth. Excess capacity is narrowing but consumer price inflation and wage pressures will remain muted.

Fiscal policy will turn from a mildly expansionary to a broadly neutral stance in 2018. As the recovery firms, the implementation of structural reforms needs to be accompanied by a gradually rising primary budget surplus. This hinges on further progress on reducing tax evasion and on rationalising fiscal expenditures and current spending. To enhance social inclusion, resources need to be shifted towards anti-poverty programmes and employment incentives targeting the young.

The large stock of banks' non-performing loans (NPLs) and the high public debt pose financial vulnerabilities. NPLs weigh on banks' balance sheets, heightening risks for public finances in the event of a crisis. The high public debt constrains fiscal policy by making it overly sensitive to changes in interest rates. The government's strategy to deal with weak banks is bearing fruit and NPLs have started to decline.

### ***The recovery is broadening***

The growth of business investment, especially in machinery and equipment, has increased due to generous investment tax incentives and firms' need to renew their productive capacity. Rising external demand is sustaining export growth. Employment growth has been resilient despite the expiration of social-security contribution exemptions



1. Harmonised consumer price index (HICP). Core HICP excludes energy, food, alcohol and tobacco. Projection from 2017Q4.

2. Real gross fixed capital formation.

3. Based on monthly data.

Source: OECD Economic Outlook 102 database; and National Institute of Statistics (ISTAT).

StatLink <http://dx.doi.org/10.1787/888933631779>

**Italy: Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
<b>GDP at market prices</b>	1 622.8	0.9	1.1	1.6	1.5	1.3
Private consumption	985.8	2.0	1.5	1.4	1.0	0.9
Government consumption	313.3	-0.6	0.5	1.0	0.4	0.4
Gross fixed capital formation	271.9	1.7	3.0	2.3	3.5	3.0
Final domestic demand	1 571.0	1.5	1.6	1.5	1.3	1.2
Stockbuilding <sup>1</sup>	5.3	0.0	-0.3	0.2	0.2	0.0
Total domestic demand	1 576.3	1.4	1.2	1.7	1.5	1.2
Exports of goods and services	475.3	4.2	2.6	4.7	3.4	3.9
Imports of goods and services	428.8	6.6	3.3	5.5	3.6	3.8
Net exports <sup>1</sup>	46.5	-0.5	-0.1	-0.1	0.0	0.1
<i>Memorandum items</i>						
GDP deflator	–	0.9	0.8	0.4	1.3	1.3
Harmonised index of consumer prices	–	0.1	-0.1	1.4	1.2	1.4
Harmonised index of core inflation <sup>2</sup>	–	0.7	0.5	1.0	1.1	1.4
Unemployment rate (% of labour force)	–	11.9	11.7	11.2	10.5	10.1
Household saving ratio, net (% of disposable income)	–	3.1	3.3	2.8	3.0	2.9
General government financial balance (% of GDP)	–	-2.6	-2.5	-2.1	-1.6	-1.1
General government gross debt (% of GDP)	–	158.9	157.3	157.0	155.2	153.1
General government debt, Maastricht definition (% of GDP)	–	131.6	131.9	131.6	129.8	127.7
Current account balance (% of GDP)	–	1.5	2.7	2.8	2.9	3.1

1. Contributions to changes in real GDP, actual amount in the first column.

2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 102 database.

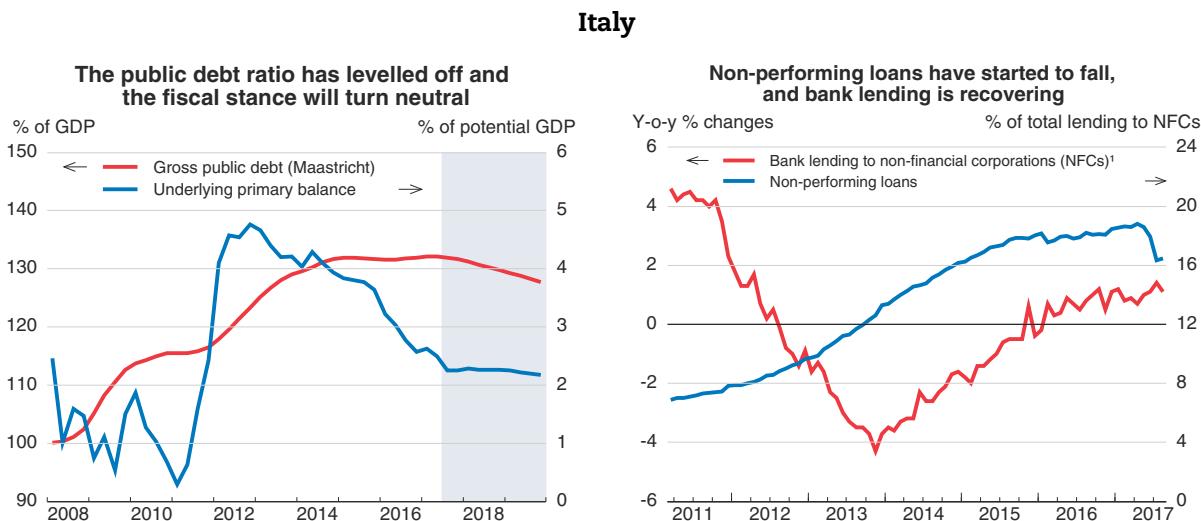
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for permanent contracts. However, job creation relies increasingly on temporary contracts. Rising real disposable income and consumer lending has supported private consumption while allowing households to rebuild their saving rate. Lending to non-financial rate corporations, adjusted for securitisation and cancellation of NPLs, is recovering.

Leading indicators for manufacturing and services, and rising business and consumer confidence, point towards robust economic activity in the near term. The share of businesses planning to increase investment in the months ahead is rising. Excess capacity is narrowing but is not yet leading to higher price and wage pressures. Firms report little pressure to raise prices because of rising wage and intermediate costs. Businesses' inflation expectations have receded from their peak earlier in the year and are low. Labour market slack remains sizeable because of increasing labour force participation and under-employment, damping wage growth.

### **Policy measures will strengthen inclusive growth and lower debt**

The fiscal stance is projected to turn neutral in 2018. The 2018 budget repeals the VAT increase planned for 2018 and appropriately extends the tax incentives for business investment and real estate improvements. It also introduces lower social security contributions for young people hired on a permanent basis, while allocating resources for raising civil servants' wages. The planned introduction of e-invoicing for



Source: OECD Economic Outlook 102 database; and Bank of Italy.

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business-to-business transactions is an important further step to reduce tax evasion. Lowering the cash payment threshold would complement these efforts. Tax expenditures without any social and economic rationale still need to be cut.

Structural reforms must continue if Italy is to enhance social cohesion and strengthen potential growth. The approval of the competition law and the progress through parliament of the enabling law reforming the insolvency system go in the right direction. The turnover due to retirement of a large share of civil servants in the near future is an opportunity to restructure the public administration.

Efforts must continue to open up local public services to competition. Fully implementing the new job search and training policies, as envisaged by the Jobs Act, and linking them to unemployment benefits will help the unemployed and discouraged job seekers. Though female labour market participation has risen, fewer than half of working-age women are in employment. Expanding childcare facilities will boost employment opportunities for women. Ensuring that the new Inclusive Income scheme is well funded will enable a reduction in poverty, especially among children. The link between the retirement age and life expectancy must be preserved to strengthen intergenerational equity and safeguard the long-term sustainability of the pension system.

Italy's main financial vulnerabilities are the high level of NPLs and public debt. NPLs sap confidence in the banking sector and are a risk for the public finances. The government has earmarked EUR 20 billion (1.2% of GDP) to deal with the banking sector, of which 50% has already been used. Its strategy has so far relied on a mix of recapitalisation and resolution. This has improved confidence and led to a large reduction in NPLs by mid-2017. The public debt ratio has stabilised but remains high. Fiscal policy is vulnerable to increases in interest rates. Continuing pro-growth reforms and gradually raising the primary surplus are key to reducing the public debt ratio.

**Growth is set to decline slightly**

GDP growth is projected to remain broadly stable in 2018 and edge down in 2019. Private consumption growth will ease following moderate wage increases and rising employment. Rising global and domestic demand and tax incentives will support export and investment growth. Increasing domestic demand will sustain import growth but the current account surplus will continue to increase.

A faster-than-expected, even if still gradual, decline in NPLs would foster confidence, further strengthening private investment. Stronger and more resilient consumer confidence might lead to lower saving and stronger private consumption. A faster global recovery would boost export growth. On the other hand, the rising share of temporary contracts could result in rising precautionary saving, reducing private consumption growth. Higher inflation in the euro area than projected could hasten the pace of monetary policy normalisation, requiring a higher primary fiscal surplus to reach the fiscal targets and reducing consumer credit, thus denting private consumption growth. Slowing down the pace of structural reforms and fiscal slippage after the planned elections in early 2018 would lower confidence and derail a durable recovery.