11. ITALY

Stagnating economic activity and further competitiveness losses

Real GDP growth in negative territory for most of 2008

The marked slowdown of real GDP growth in Italy has already been under way since mid 2007, prior to the euro area peers and well before the deepening of the financial market crisis. It turned into a contraction in the second quarter of 2008. For the second half of the year, most available indicators, in particular industrial output and business confidence, signal that the country has moved into a technical recession. It is only thanks to the first-quarter rebound – to a large extent a statistical effect after a strongly negative outturn in the final quarter of 2007 – that economic activity in 2008 is expected to be flat. This implies a negative growth impulse into 2009.

The main driver of the negative developments is domestic demand. Under the impact of accelerating price increases, in particular of the most frequently purchased goods, as well as negative wealth effects and heightened uncertainty, households are cutting their consumption. This entails a substantial rise in the household savings rate in 2008, also on the back of substantial wage and employment growth. Falling demand and tightening financial conditions are leading firms to scale back their investment plans. Residential investment is bound to slow down in line with the sharp deceleration in loans for house purchases. In the external sector, imports are expected to contract compared with 2007 as domestic demand falls. Exports are slowing down after the rebound recorded in the first quarter of the year, under the lagged impact of the appreciation of the euro and deteriorating cost competitiveness. By sector, industry is the main driver of the quarterly real GDP contractions. The services sector continues to expand, albeit at a very slow pace.

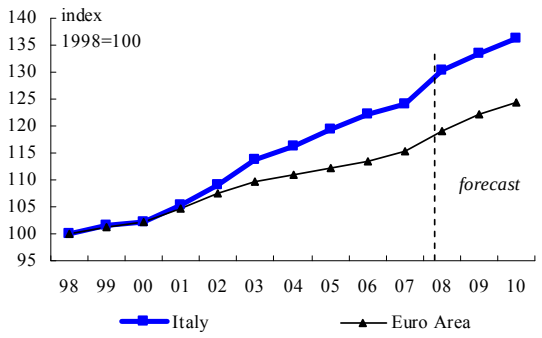
Lower inflationary pressures to support a mild recovery

Inflation is estimated to have peaked in the third quarter of 2008. Under the assumption of decelerating energy and non-oil commodity prices, it will return to 2% in 2009. The energy component of the HICP index will decline relative to 2008, whereas the unprocessed food component will moderate. Core inflation will decelerate but will remain slightly more dynamic than headline inflation throughout the forecast horizon.

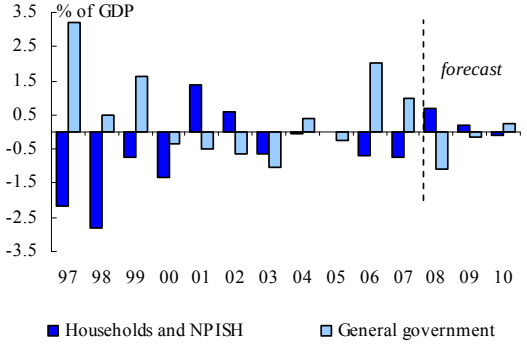
Lower inflation and some further wage increases will sustain real disposable incomes. A mild recovery in private consumption will gradually set in throughout 2009 and 2010, resulting in a stabilisation of the household savings rate. Prospects for a recovery of gross fixed capital formation appear to be somewhat further away. The negative impact of tighter financial conditions, decreasing profitability, lower confidence and sluggish demand will affect private investment throughout 2009. Only in 2010 will it recover pace, in particular as the turnaround in demand will support equipment investment. As for public investment, its dynamics will be affected by the planned containment of government expenditure.

With prospects of subdued global demand, on the one hand, and the assumed depreciation of the euro, on the other, export growth will gradually resume some strength in the second part of 2009

Graph 3.11.1: **Italy - Unit labour costs vs. euro area**



Graph 3.11.2: **Italy - Annual change in sectoral gross savings**



and more decisively in 2010. This will not prevent further losses of market shares. The recovery of import growth will be marginally stronger, entailing a slightly negative contribution of net exports to real GDP growth in 2010. Nevertheless, after increasing in 2008, the current account deficit will narrow in 2009 and 2010, as Italy's terms of trade are projected to improve thanks to lower commodity prices.

Overall, real GDP is expected to stagnate also in 2009 and to increase by 0.6% in 2010.

The labour market loses some of its vigour

Relatively robust employment growth in the first half of 2008, particularly in the services sector, is providing yet another illustration of the resilience displayed by the labour market over the past several years. In the forecast scenario, employment is set to increase by 0.7% in 2008 as a whole, assuming some contraction in the last two quarters of the year. Unemployment, however, is projected to increase for the first time in ten years as new jobseekers, many of them women and new or newly recorded immigrants, outnumber new hires. Under the lagged impact of the significant slowdown in economic activity, employment growth is projected to stall in 2009, before resuming pace in 2010. The unemployment rate is expected to continue increasing gradually, as the rise in the labour force still outpaces employment growth.

Labour productivity decreases substantially in 2008 and is forecast to remain virtually flat in 2009 and 2010. This scenario highlights the persistent productivity challenge for the Italian economy, with little prospects for any decisive improvement in the medium term in the absence of bold structural reforms. Moderate demand and sluggish productivity growth adversely affect profitability: the gross operating surplus is expected to decelerate markedly in 2008 and will not recover over the forecast period.

The wage agreements signed since late 2007 in many sectors of the economy, both private and public, are at the basis of the marked acceleration in compensation per employee in 2008. Combined with negative labour productivity growth, this gives rise to a sharp speeding up of unit labour costs and continues to weigh on the competitive position of the Italian economy, both within the euro area and against the rest of the world. In 2009, labour cost growth should ease; in real terms it will be broadly in line with productivity growth in both 2009 and 2010. In other words, the forecast scenario assumes that the recent sizeable increases in wages will not be repeated in the next few years and therefore will not generate second-round effects on prices. If that were not the case, accelerating domestic input prices would promote the diffusion and duration of inflationary and wage pressures.

Structural budgetary position to worsen in 2008…

After falling to 1.6% of GDP in 2007, its lowest level since 2000, the government deficit is forecast to increase again in 2008, to 2½% of GDP. The adverse economic cycle, together with discretionary expansionary measures, including the sizeable increase in compensation of employees, will lift the expenditure to GDP ratio by almost ¾ pp. compared with 2007. A marginal decline – ¼ pp. of GDP – is projected on the revenue side. Direct taxes, in particular on personal income, continue to display healthy growth, supported by the increase in employment and wages. By contrast, indirect taxes are declining on the back of sluggish private consumption and discretionary cuts.

The substantially higher headline deficit in 2008 relative to 2007 implies that the structural balance, i.e. the balance adjusted for the effects of the cycle and excluding one-offs, will worsen by ½ pp. of GDP. This follows the substantial structural improvement achieved over 2006-2007 to correct the excessive deficit, by around 3 pp. of GDP.

…before improving in 2009-2010 thanks to the three-year fiscal package

The forecast for 2009 and 2010 incorporates the impact of the three-year fiscal package that was approved by Parliament in the summer. With it, the government substantiated its commitment to achieving the medium-term objective of a balanced budget in 2011, mainly through a progressive containment of expenditure at all levels of government. The deficit targets for 2009 and 2010 were set at 2.1% and 1.2% of GDP, with real GDP growing by 0.5% and 0.9%, respectively.

In the Commission services' forecast, the headline deficit in 2009 will increase slightly compared with 2008, to 2.6% of GDP. This forecast assumes

the firm implementation, at all levels of government, of the expenditure cuts envisaged in the fiscal package and confirmed in the draft 2009 budget presented to Parliament in September. On the revenue side, corporate income taxes are expected to fall, also because of the delayed impact of the economic downturn, while indirect taxes will gradually recover. Compared with the official target, the higher deficit forecast is essentially explained by lower GDP growth. In structural terms, the 2009 government balance will improve by ½ pp., bringing it back to the level seen in 2007.

In 2010, resolute consolidation efforts in a context of slightly positive economic growth will allow reducing the headline deficit to 2.1% of GDP. Starting form a more unhealthy budgetary position, the remaining difference with the official deficit target for 2010 is due to the lower expected economic growth, a more cautious projection of direct tax developments and the incorporation of some limited expenditure slippages, in particular at local level. The structural balance will improve again by ½ pp. of GDP relative to 2009.

The expected economic stagnation and a still low primary surplus – at around 2½% of GDP - will prevent any reduction in the government debt ratio in 2008 and 2009 from the 104.1% of GDP recorded in 2007. A slight decline is projected only in 2010 on the back of a higher primary surplus.

Downside risks to the forecast

Despite the relatively low indebtedness of the Italian private sector, there are risks of a more significant transmission of the financial crisis to the real economy. These risks primarily relate to consumer confidence: should it remain at very low levels or worsen further, private consumption will stay even more subdued than projected. In this context, this forecast assumes a consistent implementation of the planned fiscal consolidation effort, which will play a crucial positive role by anchoring consumers' and businesses' expectations of an orderly resolution of the crisis. Still, the execution of the expenditure containment provisions in the fiscal package is not without challenges, as they mainly take the form of financial constraints and leave it to the administrations in charge to define how the savings will be achieved, requiring them to increase spending efficiency.

Table 3.11.1:

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 constant prices		1535.5	100.0	1.4	0.6	1.8	1.5	0.0	0.0	0.6
Private consumption		906.3	59.0	1.3	0.9	1.1	1.5	-0.5	0.2	1.2
Public consumption		304.0	19.8	0.8	1.9	0.8	1.2	1.1	0.6	0.5
Gross fixed capital formation		323.3	21.1	1.5	0.7	2.5	1.2	-0.3	-1.5	-0.5
of which : equipment		138.8	9.0	2.0	1.3	3.5	-0.1	-0.7	-1.4	0.4
Exports (goods and services)		448.3	29.2	4.6	1.0	6.2	5.0	0.3	-0.1	1.8
Imports (goods and services)		453.0	29.5	3.9	2.2	5.9	4.4	-1.2	0.0	2.2
GNI at previous year prices (GDP deflator)		1527.4	99.5	1.5	0.8	2.0	1.1	-0.5	0.2	0.5
Contribution to GDP growth :		Domestic demand		1.2	1.1	1.3	1.4	-0.2	0.0	0.7
		Stockbuilding		0.0	-0.2	0.4	0.0	-0.3	0.1	-0.1
		Foreign balance		0.2	-0.3	0.1	0.1	0.4	0.0	-0.1
Employment				0.2	0.2	1.7	1.0	0.7	0.0	0.5
Unemployment rate (a)				10.0	7.7	6.8	6.1	6.8	7.1	7.3
Compensation of employees/f.t.e.				3.4	3.2	2.5	1.9	4.4	2.2	2.3
Unit labour costs whole economy				2.2	2.8	2.3	1.5	5.1	2.2	2.3
Real unit labour costs				-1.0	0.7	0.6	-0.8	1.8	-0.1	0.1
Savings rate of households (b)				-	-	15.1	14.2	15.1	15.4	15.2
GDP deflator				3.3	2.1	1.7	2.3	3.3	2.3	2.2
Harmonised index of consumer prices				3.2	2.2	2.2	2.0	3.6	2.0	2.1
Terms of trade of goods				0.0	-2.3	-3.3	1.5	-1.6	1.7	0.7
Trade balance (c)				2.0	0.0	-0.7	0.1	0.1	0.5	0.6
Current account balance (c)				0.7	-1.2	-2.0	-1.7	-2.1	-1.6	-1.6
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.8	-1.1	-1.8	-1.6	-2.1	-1.8	-1.7
General government balance (c)				-4.8	-4.3	-3.4	-1.6	-2.5	-2.6	-2.1
Cyclically-adjusted budget balance (c)				-4.5	-4.2	-3.5	-1.8	-2.3	-1.9	-1.2
Structural budget balance (c)				-	-4.8	-3.1	-2.0	-2.5	-2.0	-1.3
General government gross debt (c)				112.6	105.9	106.9	104.1	104.1	104.3	103.8

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