EUROPEAN COMMISSION

DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS



ECONOMIC FORECASTS SPRING 2006

(The definitive version will be published as European Economy n° 2/2006)

10. Italy

Modest upturn, but still below the euro area performance

Activity in 2005

Following a mild recovery in 2004, real GDP stagnated again in 2005 as it did in 2002 2003. This confirmed the structural weakness of the Italian economy, in a period of global upswing.

Private consumption was very weak and investment contracted. Persistent difficulties in public finances may have affected economic actors' confidence. The contribution of domestic demand to economic growth was marginally positive only thanks to increasing government consumption. On the external side, real exports continued to record a large loss of market shares and net exports acted as a drag on GDP growth.

Employment, measured in full-time equivalent terms, which had held up well during the previous years of feeble economic growth, decreased in 2005, for the first time since 1994. However, the increase in head count employment recorded by the Labour Force Surveys continued to be surprisingly solid, mainly reflecting immigrants' regularisation.

HICP inflation averaged 2.2%, in line with that in the euro area, although the impact of higher energy prices was less pronounced.

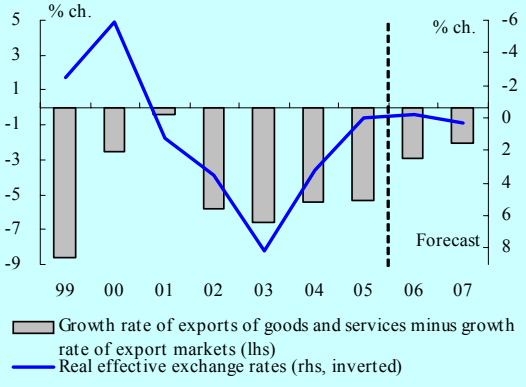
Prospects for 2006 and 2007

Signs of an improving short-term outlook started materialising only at the end of 2005, when industrial production and orders rebounded after the unexpected fall recorded in early autumn. However, this did not prevent a flat real GDP in the last quarter of 2005, which implies a weaker carryover into 2006 than assumed in the autumn 2005 forecasts. On the back of improving business confidence and increasing industrial production, real GDP is expected to accelerate in the first part of 2006, with quarterly rises slightly above potential. On an annual basis, the economy is projected to expand by 1.3% in 2006, before decelerating slightly to 1.2% in 2007 due to the impact of increasing oil prices.

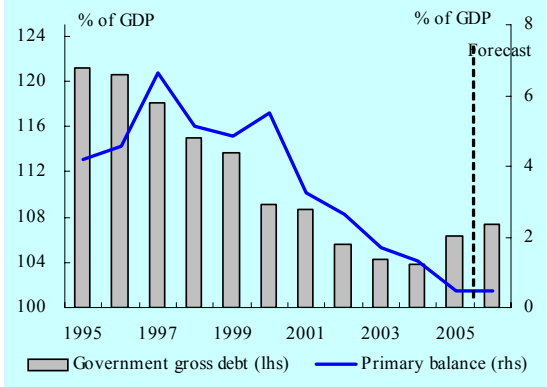
Over 2006-2007, the recovery is expected to be largely driven by domestic demand, while the contribution to economic growth from net exports is expected to be broadly neutral.

After the negative reading at the end of 2005, private consumption is projected to regain steam already at the beginning of 2006. Underpinned by a revival of job creation and nominal wages growing above inflation, private consumption should expand by 1.0% and 1.1% in 2006 and 2007, respectively. The households' saving rate is expected to remain stable. Public consumption is projected to decelerate due to the effects of the 2006 budget. Increased confidence and stronger demand prospects should trigger a pick up in investment, which should also be supported by still favourable financial conditions, in spite of rising interest rate expectations. Companies will also benefit from the reduction in the employers' social contribution rate of up to 1% implemented in the 2006 budget. Following the fall recorded in 2005, public investment is expected to rebound. Overall, gross fixed capital formation is expected to represent the most dynamic component of domestic demand and should provide a positive contribution to GDP growth

Graph 3.13: **Italy - Real effective exchange rate and export market performance**



Graph 3.14: **Italy - Government gross debt and primary balance**



of ½% both in 2006 and in 2007.

Concerning the external sector, exports are set to accelerate in real terms. However, they will expand at only around half the pace assumed in corresponding export markets, due to persistent competitiveness problems, partly related to structural shortcomings like the product specialisation of the Italian economy. After the high elasticity to final demand recorded in 2005, imports are assumed to grow in line with their long term elasticity over 2006 2007.

Labour market, costs and prices

The projected economic upturn in 2006 and 2007 should push employment up again, even when measured in full-time equivalents. Nevertheless, the labour content of economic growth is expected to be lower than in the recent past, as the effects of labour market reforms introduced since the mid 1990s seem to be fading away. The unemployment rate is projected to remain stable at 7¾% in both 2006 and 2007.

On the back of more favourable cyclical conditions, but still constrained by low specialisation in high technology/growth sectors, labour productivity is forecast to increase by 1% both in 2006 and 2007, approaching rates more consistent with historical figures. Higher labour productivity growth together with the projected deceleration of wage costs in the private sector, which should also be curbed by the reduction in social contributions, should result in a slowdown of unit labour costs. This would have a positive impact on the competitive position of the Italian economy, especially vis-à-vis non-EU countries, and mitigate somewhat the loss of market shares in 2006 and 2007.

The more moderate unit labour costs growth will also contribute to keeping core inflation below 2% over 2006-2007. However, on the back of higher oil prices, headline HICP inflation is expected to remain above 2% in 2006 and to fall to 2.0% in 2007.

Public finances

In 2005, the deficit increased to 4.1% of GDP, up from 3.4% of GDP in 2004[1]. The primary surplus shrank to a meagre 0.5% of GDP, from 1.3% in 2004. Interest expenditure, including swap-related savings, dropped by around 0.2% of GDP. The budgetary impact of one-offs declined to around ½ of a percentage point of GDP, from about 1¼% in 2004. The structural balance, i.e. the cyclically adjusted deficit excluding one-off measures, improved by more than ½% of GDP. The primary structural surplus increased by nearly ½% of GDP.

In 2006, the general government deficit is forecast to remain stable at 4.1% of GDP. The impact of one-off measures (sales of real estate and revenues from taxes on the revaluations of corporations' assets and tax amnesties) is expected to diminish further to ¼ of a percentage point of GDP. Increased interest rates and the rising government debt would prevent a further reduction of interest expenditure, which is projected to remain broadly stable at around 4½ % of GDP. The primary surplus would remain at around ½% of GDP. Net of cyclical factors and excluding one-off measures, both the deficit and the primary balance are projected to improve by slightly less than ¼ of a percentage point of GDP, thus well below the ¾ recommended by the Council in its recommendation under Article 104(7).

The 4.1% of GDP deficit forecast for 2006 contrasts with the official projections in the 2005 update of the stability programme, which targeted a 3.5% of GDP deficit this year, assuming the full implementation of the 2006 and previous Budget Laws. However, despite the better than expected 2005 deficit outturn, on 5 April, the Ministry of Economy and Finance revised the official deficit forecast upward, to 3.8% of GDP, which mainly reflects expenditure overruns.

Given the record of regular overruns, confirmed by the new official forecast, the Commission services are more prudent in their assessment of the size of savings foreseen in the 2006 Budget Law through substantial cuts on health care and other government expenditure, in particular of local government. Moreover, in accordance with the new official forecast of 5 April, the lack of implementation of the measures on public employment envisaged in previous budgets would lead to higher expenditure for compensation of employees. On the revenue side, Commission projections are overall in line with those in the Budget Law, except for the additional revenue to be realised by regions having a structural deficit in health care accounts, as the procedures necessary to trigger this increase have not yet been fully implemented.

Concerning the risks linked to the Commission projections for public finance, the new mechanisms to enforce the ambitious expenditure cuts foreseen in the 2006 budget might turn out to be more effective than assumed. However, the Commission services forecast already incorporates a sizeable share of such savings, which might prove challenging to achieve. In addition, the large cuts in transfers to State-owned railways and road maintenance companies planned in the Budget Law might be difficult to sustain given their current financial needs. Finally, the new tax agreement with self-employed professionals and small firms still needs to be put in place. The forecast for a 2007 deficit of 4.5% of GDP is based on the customary no policy change scenario and mainly reflects higher interest expenditure and no one-off measures.

In 2005, the government debt ratio increased for the first time in ten years, to attain 106½% of GDP, up from 103¾% in 2004. This was the result of the combined effect of stagnation and the very low primary surplus. Debt-increasing financial transactions amounted to around 1¼% of GDP, of which ½% of investment in liquid assets. Privatisation receipts dropped to 0.3% of GDP in 2005, from 0.6% in 2004.

The government debt ratio is forecast to increase again in 2006 by around 1% of GDP. This forecast incorporates the high cash borrowing requirement estimated in the new official forecast released on 5 April and includes privatisation receipts amounting to around ¾ of a percentage point of GDP as planned in the 2005 stability programme. Based on the no-policy-change scenario and the stock-flow adjustment planned in the 2005 stability programme, the debt-to-GDP ratio should further increase by ¼% in 2007.

[1] On 1 March 2006 the government deficit was revised by around 0.2% of GDP for all the years from 2002 to 2004. The upward revision of nominal GDP has substantially reduced the debt ratio.

Table 3.10

Main features of country forecast - ITALY

	2004			Annual percentage change						
	bn Euro	Curr. prices	% GDP	81-01	2002	2003	2004	2005	2006	2007
GDP at constant prices		1388.9	100.0	2.0	0.3	0.0	1.1	0.0	1.3	1.2
Private consumption		814.4	58.6	2.1	0.2	1.0	0.6	0.1	1.0	1.1
Public consumption		275.5	19.8	1.5	2.1	2.0	0.5	1.2	0.6	0.6
Gross fixed capital formation		286.5	20.6	1.7	4.0	-1.7	2.2	-0.6	2.3	2.2
of which : equipment		121.0	8.7	2.6	2.0	-5.8	3.3	-1.1	3.6	3.4
Exports (goods and services)		351.9	25.3	4.4	-4.0	-2.4	3.0	0.3	3.5	3.1
Final demand		1731.1	124.6	2.4	0.2	0.2	1.4	0.2	1.8	1.6
Imports (goods and services)		342.3	24.6	4.3	-0.5	0.8	2.5	1.4	3.4	3.2
GNI at constant prices (GDP deflator)		1381	99.4	1.9	0.2	0.0	1.3	0.2	1.3	1.2
Contribution to GDP growth :	Domestic demand			1.9	1.3	0.6	0.9	0.2	1.2	1.2
	Stockbuilding			0.1	0.0	0.2	0.0	0.1	0.1	0.0
	Foreign balance			0.1	-1.0	-0.8	0.1	-0.3	0.0	0.0
Employment				0.4	1.3	0.6	0.0	-0.4	0.2	0.2
Unemployment (a)				9.5	8.6	8.4	8.0	7.7	7.7	7.7
Compensation of employees/head				7.6	2.7	3.7	3.5	2.9	2.6	2.7
Unit labour costs				5.9	3.7	4.3	2.4	2.5	1.5	1.7
Real unit labour costs				-1.0	0.3	1.2	-0.5	0.4	-0.6	-0.4
Savings rate of households (b)				-	-	15.9	16.8	16.7	16.8	16.8
GDP deflator				6.9	3.4	3.1	2.9	2.1	2.0	2.1
Private consumption deflator				6.8	2.9	2.8	2.6	2.3	2.4	2.1
Harmonised index of consumer prices				-	2.6	2.8	2.3	2.2	2.2	2.0
Trade balance (c)				0.7	1.1	0.7	0.6	0.0	-0.3	-0.3
Current account balance (c)				0.0	-0.3	-0.9	-0.5	-1.1	-1.5	-1.4
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				0.1	-0.3	-0.7	-0.4	-0.9	-1.4	-1.3
General government balance (c)(d)				-8.2	-2.9	-3.4	-3.4	-4.1	-4.1	-4.5
Cyclically-adjusted budget balance (c)(d)				-8.0	-3.4	-3.4	-3.3	-3.4	-3.4	-3.8
General government gross debt (c)				97.3	105.5	104.2	103.8	106.4	107.4	107.7

(a) as % of civilian labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.
(d) Including proceeds relative to UMTS licences (see for more details note 10 on concepts and sources).