8. ITALY

Italy is rebounding from a deep output trough, but the pandemic and its negative repercussions persist and weigh on economic activity, especially services, over the forecast period. The recovery is unlikely to be sufficient for real output to return to pre-pandemic levels by 2022. After the sharp increase expected in 2020, the government deficit and debt are set to slowly decline in 2021 and 2022. Consumer price inflation is projected to turn slightly negative this year and to start picking up moderately in 2021.

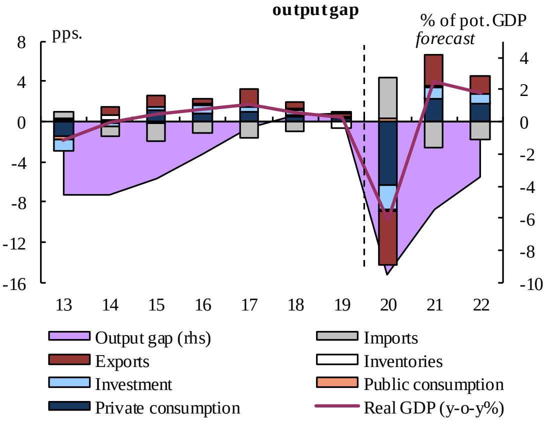
The manufacturing sector is leading a strong but fragile rebound amid high uncertainty

The COVID-19 pandemic cast a grim shadow over economic activity in the first half of this year, when real output contracted by 18%. However, after the end of the lockdown, Italy's economy picked up quickly, led by construction and industrial production, which by August had both exceeded their January levels. By contrast, consumer services, which are more sensitive to rising infection rates and mobility restrictions, are set to remain in the grip of pandemic-related constraints even after this year. Real GDP is forecast to drop by 10% in 2020, despite sizeable policy support cushioning the impact of the pandemic shock. In 2021, a substantial carryover effect should support output growth projected at 4%, albeit impaired by the recent sharp flare-up of the pandemic and the tightening of containment measures. In 2022, growth is set to slow to 2¾%, which means that the economy's level of output will remain below its pre-pandemic level. The outlook is subject to high uncertainty and pandemic-related downside risks.

Domestic demand is set to be the backbone of the recovery, albeit prone to pandemic-inflicted setbacks

As forced savings spawned pent-up demand, consumer spending bounced back sharply following the end of the lockdown. However, household surveys indicate that this effect has come to a halt with the re-emergence of the virus sapping confidence, and high uncertainty is likely to keep household savings above pre-pandemic levels. Private consumption is expected to strengthen again in the course of 2021, also helped by the new family bonus. Amid firms' unused capacity, liquidity concerns and a decline in business start-ups, investment shrunk substantially in the first half of this year. Capital spending is set to pick up sizeably over the next two years, also thanks to public investment and fiscal incentives for improving the energy efficiency of residential buildings, while future spending related to the Recovery and Resilience Facility constitutes an upside risk. After a steep drop this year, goods exports are set to rebound, limiting market share losses. However, services exports, in particular tourism, are unlikely to fully recover by 2022.

Graph II.8.1: **Italy - Real GDP growth and contributions, output gap**



Employment has held up but will suffer once policy support is phased out

The extended coverage for wage supplementation schemes (Cassa integrazione guadagni) and a dismissal ban until early next year is likely to prevent major job losses in 2020. Temporary workers have borne the brunt of the labour market adjustment so far, but permanent employees are unlikely to remain unscathed, once emergency policy measures expire. Together with the return of the labour force to pre-pandemic levels, the jobless rate is set to rise above 11%, with job losses concentrated among service-sector workers.

Oil prices set to shape HICP inflation dynamics

Consumer prices are likely to fall slightly this year, given downward pressure from oil prices and subdued core inflation. In 2021, base effects due to energy prices and the rise of services prices are set to push headline inflation into positive territory. In 2022, HICP inflation is forecast to average 1.0%.

Public finances set to slowly recover from 2021

Following an historical low of 1.6% of GDP in 2019, the government headline deficit is expected to sharply increase to around 10¾% of GDP in 2020, as an effect of the COVID-19 pandemic. Revenues from indirect taxes are expected to fall as a result of the drop in private consumption. The deterioration of the labour market, albeit contained by public support, implies lower revenues from direct taxes and social security contributions. Conversely, under a no-policy-change assumption, the deferral of tax payments to 2021 and 2022 is not expected to affect the 2020 deficit. The policy response to the crisis, which provided substantial support to workers and firms, implies a budgetary impact of around 5½% of GDP in 2020, mainly on the expenditure side.

In 2021, the government deficit is expected to decline to around 7¾% of GDP. Government revenues should benefit from the rebound in economic activity while government spending is set to decline, as most support measures adopted in 2020 were temporary. At the same time, the fiscal expansion announced in the draft budgetary plan will weigh on public finances. The main planned deficit increasing measures include the extension of public support to sectors most affected by the crisis, a cut in social security contributions for firms operating in poorer regions, the introduction of a family bonus and additional resources for healthcare, education and research. In 2022, under a no-policy-change assumption, the government deficit is expected to further decline to 6% of GDP, supported by economic growth and the improving labour market. This forecast does not include any measures funded by grants from the Recovery and Resilience Facility and the corresponding growth and second-round revenue effects, as these measures have not yet been sufficiently specified.

The government debt-to-GDP ratio is expected to increase sharply from 134.7% in 2019 to around 159½% in 2020 before slowly declining to about 159% in 2022, thanks to nominal GDP growth. The government primary balance is projected to remain negative over 2020-2022, while interest expenditure is expected to steadily decline in light of favourable financing conditions. Liquidity support measures to firms, including government guarantees, imply some risks to the debt projections.

Table II.8.1:

Main features of country forecast - ITALY

	2019			Annual percentage change						
	bn EUR Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	1789.7	100.0	0.1	1.7	0.9	0.3	**-9.9**	**4.1**	**2.8**
Private Consumption	1076.4	60.1	0.1	1.5	0.9	0.4	**-10.5**	**3.8**	**3.1**
Public Consumption	335.1	18.7	0.4	-0.1	0.2	-0.2	**2.1**	**0.1**	**0.3**
Gross fixed capital formation	323.2	18.1	-1.0	3.2	3.1	1.6	**-13.6**	**7.2**	**5.6**
of which: equipment	122.8	6.9	-0.5	6.4	4.4	0.9	**-18.8**	**9.4**	**7.6**
Exports (goods and services)	563.8	31.5	1.6	5.4	2.2	1.0	**-16.7**	**10.3**	**5.9**
Imports (goods and services)	509.2	28.5	1.3	6.1	3.5	-0.6	**-14.1**	**9.9**	**6.4**
GNI (GDP deflator)	1805.1	100.9	0.1	1.9	1.5	0.1	**-9.3**	**3.6**	**2.9**
Contribution to GDP growth: Domestic demand			-0.1	1.5	1.1	0.5	**-8.4**	**3.5**	**2.8**
Inventories			0.0	0.2	0.1	-0.7	**-0.2**	**0.2**	**0.0**
Net exports			0.1	0.0	-0.3	0.5	**-1.3**	**0.4**	**0.0**
Employment			0.1	0.8	0.7	0.2	**-10.3**	**6.1**	**2.4**
Unemployment rate (a)			9.2	11.2	10.6	10.0	**9.9**	**11.6**	**11.1**
Compensation of employees / f.t.e.			2.1	0.6	2.1	1.5	**0.9**	**0.6**	**0.7**
Unit labour costs whole economy			2.1	-0.3	1.9	1.3	**0.5**	**2.5**	**0.2**
Real unit labour cost			0.2	-1.0	0.8	0.6	**-0.8**	**1.5**	**-1.0**
Saving rate of households (b)			12.7	10.2	10.1	10.1	**15.2**	**12.6**	**10.3**
GDP deflator			1.9	0.7	1.0	0.7	**1.3**	**1.0**	**1.2**
Harmonised index of consumer prices			1.9	1.3	1.2	0.6	**-0.1**	**0.7**	**1.0**
Terms of trade goods			0.3	-1.9	-1.2	1.3	**3.4**	**0.3**	**0.5**
Trade balance (goods) (c)			0.9	3.1	2.6	3.2	**3.6**	**4.0**	**4.0**
Current-account balance (c)			-0.6	2.5	2.5	3.0	**2.9**	**3.1**	**2.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-0.5	2.6	2.5	2.8	**2.7**	**2.9**	**2.8**
General government balance (c)			-3.2	-2.4	-2.2	-1.6	**-10.8**	**-7.8**	**-6.0**
Cyclically-adjusted budget balance (d)			-2.9	-2.2	-2.4	-1.9	**-5.6**	**-4.8**	**-4.1**
Structural budget balance (d)			-3.4	-2.2	-2.6	-1.9	**-5.8**	**-5.0**	**-4.3**
General government gross debt (c)			116.8	134.1	134.4	134.7	**159.6**	**159.5**	**159.1**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.