



Economic Assessment of the Euro Area

Winter 2011/2012 Report

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5.3 Italy

Following a slow recovery, the economic picture worsened during the third quarter, and Italy's GDP decreased by 0.2%. Growth was sustained by net exports (0.8 percentage point contribution to GDP growth), while both domestic demand and inventories contributed negatively (-0.4 percentage points and -0.5 percentage points, respectively).

Inflation has increased after the summer: in October, the twelve-month producer price inflation was still at 4.7%, and in December consumer price inflation reached 3.4%. Prices have already incorporated the VAT increase enacted in September, and some measures on tariffs and taxes on fuel. Core inflation remained low. The latest business surveys and producer prices of manufactured goods indicate less pressure on input costs.

The latest indicators confirmed that domestic demand is weak. It is depressed by the poor employment outlook and mounting uncertainty over the general economic situation. Exports are at risk in the context of a world demand that is losing momentum.

The Italian outlook, however, depends primarily on the impact of the crisis on its sovereign debt. This situation remains unresolved.

During the summer, in response to the strains in the financial markets, the Italian Government approved two austerity packages for the years 2011-2014. These fiscal packages were aimed at addressing the main problem of the Italian public finances - the need to reduce public debt, and at reassuring financial markets. Together, the two packages provide a reduction in the net borrowing that is officially estimated to be €2.8 billion in 2011 (0.2% of GDP), €28.3 billion in 2012 (1.7% of GDP), and €54.3 billion and €59.8 billion in 2013 and 2014, respectively (3.3% and 3.5% of GDP in 2013 and 2014, respectively).

Despite the fact that the size of the correction was consistent with the level of the Italian structural deficit (which is around 3% of GDP, 1% of which is the cyclical component), and the aim of reducing the debt/GDP ratio, the rise in the spread on Italian sovereign bonds during the autumn signalled that



the financial markets consider the probability of a consistent improvement in the Italian public finances to be very low.

There are two main reasons behind the Italian sovereign debt crisis and the rise in spreads, other than the uncertainty of governance that affects the EMU itself. On the one hand, the Italian political system lacks credibility, and this is judged to be unsuitable for the implementation of the package. On the other hand, there is a lack of reform aimed at tackling the main issues in the Italian economy, such as growth and competitiveness.

In addition, austerity will depress growth and, in the context of global economic slowdown, this is likely to have a negative impact on the fiscal balance itself. The rise in interest rate spreads represents an additional risk for the fiscal consolidation by increasing interest expenditure and by creating a vicious circle where the pessimistic mood of the markets becomes self-fulfilling.

With this background, the newly appointed Government with Mario Monti as Prime Minister has to reverse this negative trend in order to reassure the financial markets, not only with the additional fiscal correction, but also with the implementation of credible structural reforms aimed at enhancing growth. The new Ministers were appointed on November 19th and they prepared a fiscal plan, which was approved by the Parliament on November 22nd.

Considering the three plans together, they provide a reduction in the net borrowing that is officially estimated to be €48.4 billion in 2012 (3% of GDP), €75.6 billion in 2013 and €81.2 billion in 2014 (4.6% and 4.8% of GDP in 2013 and 2014, respectively).

More than 60% of the adjustment, or €51 billion in 2014, will come from increases in revenues, while spending cuts are estimated at €30 billion.

The largest effect of the measures, estimated at around €36 billion in 2012 and €60 billion in 2014 (75% of the total adjustment), will be felt by the household sector. Of this, €12 billion in 2012 and €21 billion in 2014 are expected to come from measures that will reduce households' disposable income: fiscal and welfare cuts, tax on income from financial assets, solidarity contributions on high incomes and on high pensions, savings on public employment, and significant measures in the pension system. In addition, other measures, estimated at around 22% of the total adjustment, will impact households' purchasing power: the increase in stamp duty on securities accounts, the introduction of a municipal real estate levy based on the value of properties and local services, excise taxes on fuel, tax surcharges on luxury items and a tax on the so-called 'tax shielded' assets. Finally, purchasing power will be negatively affected by the increase in the VAT rate from 20% to 21%, which is expected to increase inflation by approximately 0.5 percentage points in 2012. Another increase (from 21% to 23% and from 10% to 11%) can be implemented in September 2012 (and will be followed by a further increase in the rates of half a



percentage point in 2014) if the government does not manage to implement the law on tax and welfare reform (which would produce €13.1 billion of additional revenue in 2013 and €16.4 billion in 2014).

Only a small part of the adjustment will affect firms directly: corporate income measures (surtax on energy sector, increase in the rate of IRAP, the regional tax on productive activities, applying to bank and insurance companies and others) account for € 8 billion. In fact, there are measures aimed at enhancing growth focused mainly on firms, the most important of which are the introduction of a tax benefit for recapitalisations, the reduction of the tax wedge on labour, which is operating through tax deduction from IRAP, especially in the case of employment of women and young workers, and the re-funding of the guarantee fund for SMEs.

Spending cuts in direct public consumption and investment amount to around €18 billion. A large part of the spending cuts will be achieved through cuts in local government expenditure, €9.2 billion, and savings on the healthcare system, €5 billion.

According to our estimates, the overall impact of the package on economic activity (assuming almost complete ex-ante effectiveness of the measures) is about 2.2% of GDP in the period 2012-2014 (with respect to a baseline scenario without fiscal adjustment) of which 1.3% is in 2012, 0.7% is in 2013 and 0.2% is in 2014.

In our estimates more than 40% of the negative effect on GDP comes from the impact on private consumption, mainly through measures that affect households' disposable income directly. Moreover, real disposable income will be negatively affected by the increase in VAT. Expenditure reductions explain one third of the negative effect on GDP.

Despite the less favourable GDP growth, we expect that a "close to balance" position could be achieved in 2013.

The debt crisis is having negative effects on the Italian economy not only through the necessity for restrictive fiscal policy, but also through other channels. First of all, households are experiencing financial wealth losses through both the depreciation of Italian sovereign bonds and the reduction in value on stock exchanges. Higher interest rates also affect the cost of mortgages for households. The cost of borrowing is also affecting firms, and the risk of a new credit crunch is now very high. Given the weak economic outlook and the difficulties of more indebted firms, the latest financial crisis may have a further negative impact on growth.

All in all, without any counter-action, a new recession during the winter is expected, and all the components of GDP are forecast to decline during the next two quarters.