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Economic Bulletin

October 2023

4 2023

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Economic Bulletin

Number 4 / 2023
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For the paper-based version: registration with the Court of Rome No. 290, 14 October 1983
For the electronic version: registration with the Court of Rome No. 9/2008, 21 January 2008

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The English edition is translated from the Italian by the Language Services Division of the Secretariat to the Governing Board

Address
Via Nazionale 91 – 00184 Roma – Italia

Telephone
+39 06 47921

Website
http://www.bancaditalia.it

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ISSN 0393-7704 (print)
ISSN 2280-7640 (online)

Based on data available on 6 October 2023, unless otherwise indicated

Designed and printed by the Printing and Publishing Division of the Bank of Italy

CONTENTS

OVERVIEW 5

1 THE WORLD ECONOMY

1.1 The global cycle 7

1.2 The euro area 12

1.3 International financial markets 19

2 THE ITALIAN ECONOMY

2.1 Cyclical developments 21

2.2 Firms 22

2.3 Households 24

2.4 Foreign trade and the balance of payments 26

2.5 The labour market 28

2.6 Price developments 32

2.7 Banks 34

2.8 The financial market 39

2.9 The public finances 41

2.10 Projections 44

LIST OF BOXES

The crisis in China's real estate sector and the potential spillovers on the global economy 8

The heterogeneous developments of the components of euro-area core inflation 14

The decline in hourly labour productivity: developments at firm level 30

Credit supply and demand since the start of monetary policy normalization 35

SYMBOLS AND CONVENTIONS

Unless otherwise specified, Bank of Italy calculations; for Bank of Italy data, the source is omitted.

In the tables:

- – the phenomenon does not exist;
- .... the phenomenon exists but its value is not known;
- .. the value is nil or less than half of the final digit shown;
- :: not statistically significant;
- () provisional.

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OVERVIEW

The global economy slows down

GDP growth remained solid in the United States in the second quarter, while it decreased markedly in China, partly as a result of the housing crisis. Global economic activity slowed in the summer: growth in services abated and the manufacturing cycle contracted further. According to the IMF's projections published in October, global GDP will decelerate in 2023 and 2024. Geopolitical tensions, heightened by the recent terrorist attacks in Israel, are weighing on global economic developments. Sluggish trade in goods is affecting the world trade outlook. Energy prices turned upwards again.

The monetary policy stance remains tight in the United States and the United Kingdom

Core inflation went down in the United States and in the United Kingdom in the summer months, though it remains high. The Federal Reserve and the Bank of England increased their policy rates by 25 basis points at their meetings in July and August respectively, bringing them to the highest levels since 2007-08 and leaving them unchanged in September. By contrast, the Bank of Japan maintained an accommodative monetary policy stance. Global financial market conditions tightened in the third quarter, partly reflecting a revision of previous expectations of rapid monetary policy easing.

The euro-area economic cycle remains weak and inflation falls

According to our estimates, the stagnation underway in the euro area since late 2022 continued in the summer months, affected by tighter financing conditions and the effects of high inflation on households' purchasing power. Economic activity remains sluggish in manufacturing and is weakening in services. The labour market showed signs of a slowdown. In September, headline and core inflation declined to 4.3 per cent and 4.5 per cent, respectively. The ECB staff projections indicate that consumer price growth will decrease markedly in 2024 (to 3.2 per cent) and 2025 (to 2.1 per cent). This downturn is confirmed by lower inflation rates for the more persistent items in the basket of goods and services.

The ECB has continued to raise its key interest rates

In July and September, the Governing Council of the ECB increased its key interest rates by a total of 50 basis points. The Council currently considers that the key interest rates have reached levels that, if maintained for a sufficiently long period, will make a substantial contribution to the timely return of inflation to its 2 per cent target. It also reiterated its intention to reinvest the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) flexibly, at least until the end of 2024. In the euro area, the cost of borrowing for firms and households rose further, reflecting the rise in key interest rates. The yields on ten-year government securities increased, as did the spreads between Italian and German government bonds.

Growth in Italy remains weak in the summer

According to our assessments, economic activity in Italy has continued to be weak both in manufacturing and services, after declining in the second quarter. The indicators confirm the weakness of domestic demand, which reflects tighter credit conditions, inflation-driven household income erosion and the loss of momentum in the labour market. Sluggish global demand and economic activity in the euro area are weighing on exports.

The current account balance continues to improve

The current account balance has turned marginally positive, owing to the decrease in the energy deficit in the spring; non-resident investors expressed a keen interest in Italian government securities. Italy's positive net international investment position widened. The TARGET2 negative balance continues to improve.

Employment slows, wage growth gathers pace, and profit margins go down

The labour market showed signs of a slowdown in July and August. Employment and the participation rate remained broadly stable. Wage growth in the non-farm private sector strengthened, but upward pressures from collective bargaining agreement renewals appear to be subdued overall. Profit margins declined in all sectors.

Inflation picks up slightly as a result of higher fuel prices

Consumer price inflation rose slightly in September, reflecting higher fuel prices, following the decline recorded in the past few months. Core inflation remained broadly unchanged, well below the February high. Households and firms expect inflationary pressures to ease.

Bank loans decrease and the cost of credit rises

Between May and August, lending to households and firms decreased further. Loan applications are held back by both the higher cost of funding and the lower liquidity needed to finance investment. Bank surveys also show that financial intermediaries' higher risk perception and lower risk tolerance continue to result in tighter credit standards, thereby dampening lending growth. Banks expect a further tightening of the criteria for granting credit to firms. New non-performing loans continue to be low.

According to the Government, the debt-to-GDP ratio is set to fall only marginally over the next three years

Based on the new public finance targets, which were updated by the Government at the end of September, net borrowing and debt are projected to decline further in 2023, to 5.3 and 140.2 per cent of GDP, respectively. For 2024, the Government is planning to expand the deficit with respect to the current legislation scenario, by about 0.7 percentage points of GDP. Net borrowing is expected to continue to decline gradually over the next few years, to 2.9 per cent of GDP in 2026. The debt-to-GDP ratio is set to fall only marginally over the next three years, with risks mostly tilted to the upside.

GDP growth is projected to slow and inflation to fall significantly in 2023-25

In our baseline scenario, GDP is projected to grow by 0.7 per cent this year, 0.8 per cent in 2024 and 1.0 per cent in 2025. Growth will likely be affected by tighter financing conditions and weak international trade, while it stands to benefit from the effects of NRRP measures and a gradual recovery in household purchasing power. Inflation is projected to fall to 2.4 per cent in 2024 (from 6.1 per cent in 2023) and to 1.9 per cent in 2025. This downtrend reflects a sharp drop in import prices, largely driven by the year-on-year fall in energy commodity prices. Core inflation is projected to drop to 2.3 per cent in 2024 (from 4.6 in 2023) and to 1.9 per cent in 2025, as the effects of past energy price increases fade away and domestic demand weakens.

The risks to growth are tilted to the downside, while the inflation outlook is balanced

The heightened geopolitical tensions, China's worsening economy and the tighter credit supply conditions in Italy and in the euro area pose downside risks to economic growth. Conversely, the risks to inflation are balanced, with upward pressures coming from further increases in commodity prices and a slower pass-through of the recent decline in production costs, and downside risks mainly associated with a more marked and lasting deterioration in aggregate demand.

1 THE WORLD ECONOMY

1.1 THE GLOBAL CYCLE

The world economy slowed in the spring. Growth remained solid in the United States but fell markedly in China. At global level, the contraction in the manufacturing cycle was accompanied by signs of weakening in services in summer; the recovery in global trade slackened. In the third quarter, the reductions in oil supply led to higher oil prices, and natural gas prices rose too. In the United States and in the United Kingdom, core inflation, though remaining high, continued to go down and the monetary policy stance remained tight. Geopolitical tensions continue to weigh on the global outlook, heightened by the tragic events in the Middle East.

Growth remains solid in the United States in the second quarter and declines in China

Global economic activity slowed in the second quarter, affected by the lower momentum in some emerging economies and the ongoing monetary tightening in the main advanced economies. In the United States, thanks to the recovery in non-residential fixed investment and resilient consumption, growth remained essentially stable, in contrast to the expectations of analysts who had forecast a decrease (Table 1). GDP accelerated sharply in Japan, while it expanded at a low rate in the United Kingdom. In China, economic activity slowed significantly in cyclical terms, affected by the crisis in the real estate sector and by the weakness of domestic and foreign demand (see the box 'The crisis in China's real estate sector and the potential spillovers on the global economy').

Table 1

GDP growth and macroeconomic projections
(percentage changes)

	Growth			Forecasts		Revisions (1)	
	2022	2023 Q1 (2)	2023 Q2 (2)	2023	2024	2023	2024
World	**3.5**	**–**	**–**	**3.0**	**2.9**	**0.0**	**-0.1**
Japan	1.0	3.2	4.8	2.0	1.0	0.6	0.0
United Kingdom	4.3	1.3	0.8	0.5	0.6	0.1	-0.4
United States	1.9	2.2	2.1	2.1	1.5	0.3	0.5
Brazil	2.9	4.0	3.4	3.1	1.5	1.0	0.3
China (3)	3.0	9.1	3.2	5.0	4.2	-0.2	-0.3
India (4)	7.2	6.1	7.8	6.3	6.3	0.2	0.0
Russia	-2.1	-1.8	4.9	2.2	1.1	0.7	-0.2

Sources: For data on the growth of individual countries, national statistics; for world GDP and for all the forecasts, IMF, *IMF World Economic Outlook*, October 2023.
(1) Percentage points; revisions compared with IMF, *IMF World Economic Outlook Update*, July 2023. – (2) Quarterly data; for Japan, United Kingdom, United States and China, annualized and seasonally adjusted percentage changes on the previous quarter; for the other countries, year-on-year percentage changes. – (3) Unlike the previous Economic Bulletins, this one refers to quarter-on-quarter growth, not to year-on-year growth, since in China, the latter was affected by the exceptionally low GDP in the second quarter of 2022, when strict measures to contain the pandemic were in place. – (4) The actual data and the forecasts refer to the fiscal year starting in April.

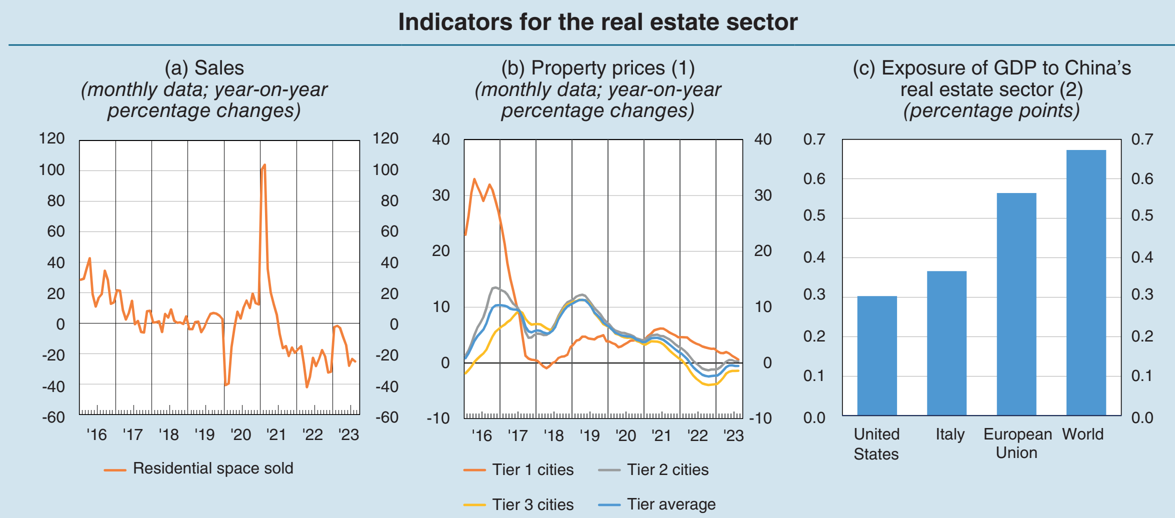
THE CRISIS IN CHINA'S REAL ESTATE SECTOR AND THE POTENTIAL SPILLOVERS ON THE GLOBAL ECONOMY

In recent months, Country Garden, the top Chinese real estate company by turnover, has repeatedly delayed the payment of interest on its foreign currency-denominated bonds. This is only the latest in a series of financial difficulties faced by companies in the sector in China in recent years (see the box 'The financial crisis of the Chinese real estate group Evergrande', in *Financial Stability Report*, 2, 2021); this has gradually deteriorated both the confidence of consumers, with negative repercussions on trade and property prices, and of international investors, as highlighted by the depreciation of the Chinese currency.

In the first eight months of 2023, the volume of sales went down by almost 30 per cent compared with the same period in 2019 (see panel (a) of the figure). At the same time, purchases of land for building by companies in the sector plummeted by more than 90 per cent. At the end of the summer, prices stagnated for the first time in the main urban areas as well, while prices had already been falling since the second half of 2022 in smaller cities (see panel (b) of the figure).

Figure

Indicators for the real estate sector



Sources: Based on data from China's National Bureau of Statistics (NBS) and the Asian Development Bank.
(1) House prices are monitored by the NBS in 70 cities, subdivided into three tiers based on their importance. The cities in the first tier are: Beijing, Shanghai, Shenzhen and Guangzhou. – (2) The height of the bar graph indicates the percentage of value added for each economy, absorbed directly or indirectly by China's real estate sector.

The real estate sector has been a key contributor to China's economic growth, whose mass urbanization has required significant investment in residential construction. Taking account of the ancillary sectors as well, according to some estimates, this sector accounted for about one quarter of GDP in 2016.[1] In addition, it is extremely important for both household wealth (more than three quarters of which is in property) and for local government finances. In cities, more than 80 per cent of households live in owned houses, one of the highest percentages in the world, and more than 20 per cent of households own more than one property. More than one fifth of local authorities' expenditure is financed by revenues from the sale of land for building. As these revenues have petered out, not only has their spending capacity decreased, but also the possibility of issuing new debt, typically secured by expectations of future proceeds from new land subdivisions.[2]

[1] K. Rogoff and Y. Yang, 'Has China's housing production peaked?', *China and World Economy*, 29, 1, 2021, pp. 1-31.

[2] Local governments implement economic stimulus policies. Despite this, they are subject to annual limits on the direct issuance of debt, which have so far forced them to call on foreign financial corporations to raise funds from savers.

In addition, over the years, construction companies have financed the implementation of residential developments mainly through sales based on projects; this practice, together with the steady growth in indebtedness, has exposed them to the risk of liquidity crises in the event of a fall in sales.

From 2020 onwards, the Government's imposition of stricter limits on the issuance of liabilities by real estate firms, as part of the policies to reducing leveraging on the economy, has actually contributed to the liquidity problems and financial tensions of recent years, fuelling households' fears of serious insolvencies among construction companies. In response, more limited and targeted measures have been adopted than in the past, consistent with the objective of curbing property speculation. Specifically, the Government has requested that: (a) construction companies invest their available liquidity in open building sites; (b) commercial banks reduce the interest rates on outstanding mortgage contracts; and (c) local governments lower the minimum percentages for down payments and relax the admission requirements for first home buyer benefits.[3]

A further sharp fall in prices could have considerable domestic and international repercussions. At domestic level, the negative effect on household wealth, together with declining confidence, would considerably dampen household consumption. The greater financial difficulty for local authorities would translate into less support for public investment. Furthermore, as highlighted by the recent default of a medium-sized financial intermediary, there could be marked negative effects on the stability of China's financial system, especially the shadow-banking system, which is very exposed to the real estate sector.

At international level, the main channels that transmit the real estate crisis are trade and the commodity markets. Our analyses indicate that the sector directly absorbs almost 0.7 per cent of global value added (almost 0.4 per cent of Italian value added; see panel (c) of the figure).[4] The available estimates show that, overall, a decrease of 15 per cent in the value of houses in China could lead to its GDP slowing by one percentage point.[5] This would in turn produce a negative impact on global growth and trade of, depending on the model used, between -0.6 and -0.3 percentage points for the former and between -0.9 and -0.3 percentage points for the latter. The decline in GDP growth would be up to 0.2 percentage points in the United States and between 0.1 and 0.5 percentage points in the euro area.[6] Commodity prices would fall in this scenario, especially those for which China is a major importer at global level. The repercussions on the international financial markets would instead be minor: on the one hand, foreign exposure of real estate companies is limited, and on the other hand, the controls on capital movements are still quite significant.[7]

[3] The change in the minimum percentage of the total price as a down payment set by law has often been used by local governments as a macroprudential policy tool to cool down or revive the market.

[4] The real estate sector is composed of: construction and real estate services. For the estimation method, see F. Belotti, A. Borin and M. Mancini, 'ICIO: economic analysis with intercountry input-output tables', *The Stata Journal*, 21, 3, 2021, pp. 708-755.

[5] D. Ding, X. Huang, T. Jin and W.R. Lam, 'Assessing China's residential real estate market', IMF Working Papers, 248, 2017.

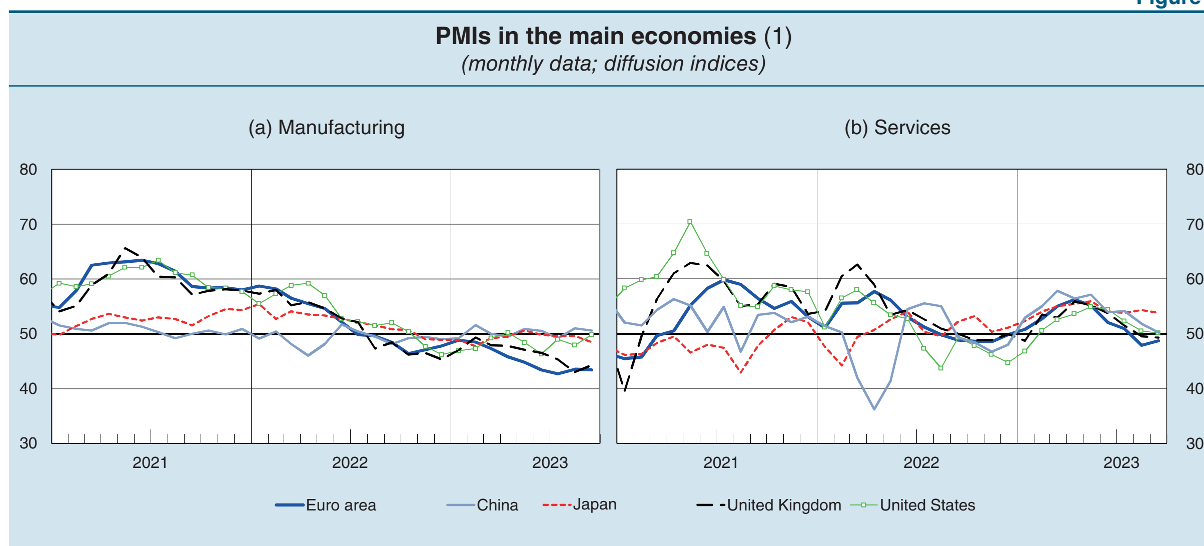
[6] The impact for Italy would be between 0.0 and 0.1 percentage points. For more details, see, for example, ECB *Economic Bulletin*, 7, 2017; OECD, *OECD Economic Outlook*, 2018; D. Furceri, J.T. Jalles and A. Zdzienicka, 'China spillovers: new evidence from time-varying estimates', *International Monetary Fund*, Spillover Notes, 7, November 2016; L. Metelli and F. Natoli, 'The effect of a Chinese slowdown on inflation in the euro area and the United States', *Economic Modelling*, 62, 2017, pp. 16-22.

[7] F. Corneli, F. Ferriani and A. Gazzani, 'Macroeconomic news, the financial cycle and the commodity cycle: the Chinese footprint', *Economic Letters*, 231, 2023, also published in Banca d'Italia, Questioni di Economia e Finanza, 772, 2023.

The contraction in manufacturing continues in the summer and activity in services slows

In the third quarter, the purchasing managers' indices (PMIs) for manufacturing firms, which had been falling since the second half of 2022, remained below the expansion threshold in the main advanced economies (Figure 1.a). In China, following a temporary improvement at the beginning of the year, the index returned to levels consistent with only moderate growth. Activity in services weakened in all the leading countries (Figure 1.b).

Figure 1



PMIs in the main economies (1)
(monthly data; diffusion indices)

Sources: Markit and Standard & Poor's.
(1) Diffusion indices for economic activity in the manufacturing and service sectors. Each index is obtained by adding half of the percentages of responses of 'stable' to the percentage of responses of 'increasing'. Values greater than 50 are compatible with expansion in the sector.

In 2023, global trade growth is expected to decrease ...

Following the timid recovery early in the year, trade flows slowed in the second quarter: the shifting of global demand towards services following the pandemic and tightened monetary policies weighed on trade in goods; trade in services instead continued to expand. The available indicators suggest that the weakness in trade continued in the third quarter and the PMIs also suggest that trade in services lost momentum. For the current year, our estimates point to a marked slowdown in international trade, to 0.8 per cent (from 5.4 per cent in 2022), much lower than the average recorded over the decade prior to the pandemic.

... as is growth in economic activity

The tight monetary policy stance in the main advanced economies, the slowdown in economic activity in China, and international tensions, linked to the protracted war in Ukraine and fuelled by the recent terrorist attacks in Israel, all continue to weigh on global growth prospects. According to the forecasts published by the IMF in October, global GDP growth is expected to decline, reaching just below 3 per cent on average in the two years 2023-24, from 3.5 per cent in 2022, with risks mainly tilted to the downside.

Oil prices go up in the summer ...

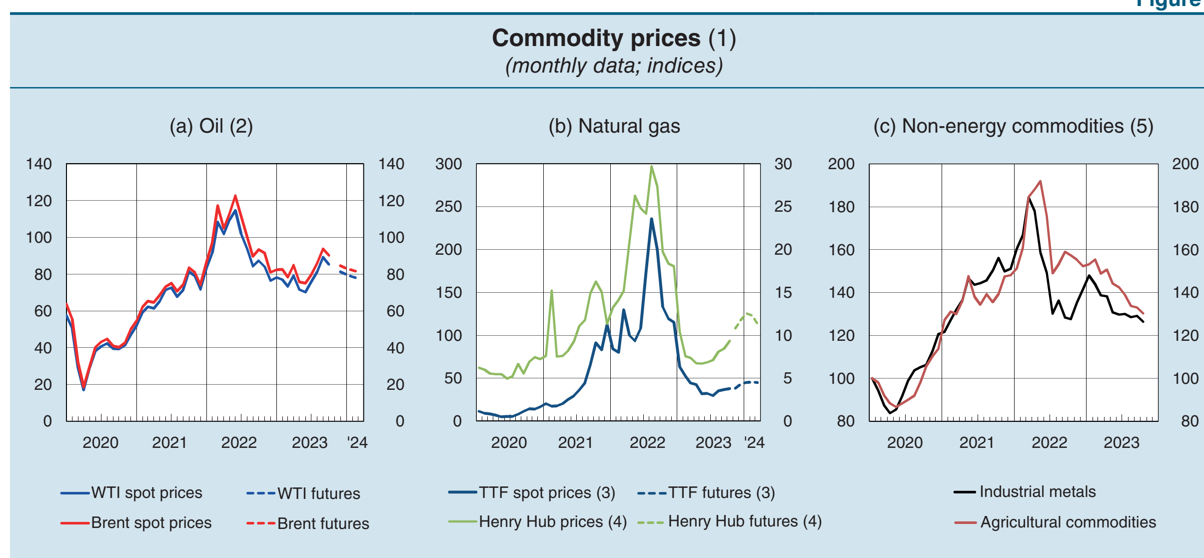
Brent crude oil prices rose to around $90 per barrel in early October (from almost $75 per barrel at the beginning of July; Figure 2.a). The increase reflects the production cuts made by OPEC+ countries (over 1 million barrels per day) and the voluntary reductions in supply made by Saudi Arabia and Russia (1.3 million barrels per day). Risks of a rise in prices could stem from the flare-up of tensions in the Middle East.

... and so do those of natural gas in Europe

The Title Transfer Facility (TTF) price of natural gas used as a reference for European markets rose to around €40 per megawatt-hour in early October, from just below €35 in early July (Figure 2.b). This trend is in line with the usual seasonal dynamics in the run-up to winter, but it has also been affected by fears of disruptions to global liquefied natural gas supplies caused by strikes at some production sites in Australia. Although stockpiles in the European Union are reaching their peak capacity, there are still risks of rising gas prices in the coming months, due to the uncertainty on the one hand relating to the heightened geopolitical tensions and on the other hand to the recovery in European and Asian demand for industrial uses and to potentially higher consumption should next winter be colder than usual. The weakness of global activity and, in particular, the slowdown in China are putting downward pressures on the prices of industrial metals and agricultural commodities (Figure 2.c). Counter to the trend in the overall index, rice recorded significant growth as a result of India's export restrictions. The increases in wheat prices observed in July, following the expiry of the agreement between Russia and Ukraine to enable exports from Ukrainian ports, have been reversed thanks to larger supplies from Russia.

Figure 2

Commodity prices (1)
(monthly data; indices)



Sources: Refinitiv for oil and natural gas prices; Standard & Poor's for non-energy commodities.
(1) For spot prices, monthly averages up to September 2023. The October 2023 figure refers to the average of the daily data from 2 to 6 October 2023. For futures, the data refer to the prices on 6 October 2023. – (2) Dollars per barrel. – (3) Euros per megawatt-hour. Price of natural gas traded on the Dutch TTF market. – (4) Euros per megawatt-hour. Price of gas distributed via the Henry Hub in Louisiana (USA). Right-hand scale. – (5) Indices: January 2020=100.

Core inflation goes down in the United States and in the United Kingdom, but not in Japan

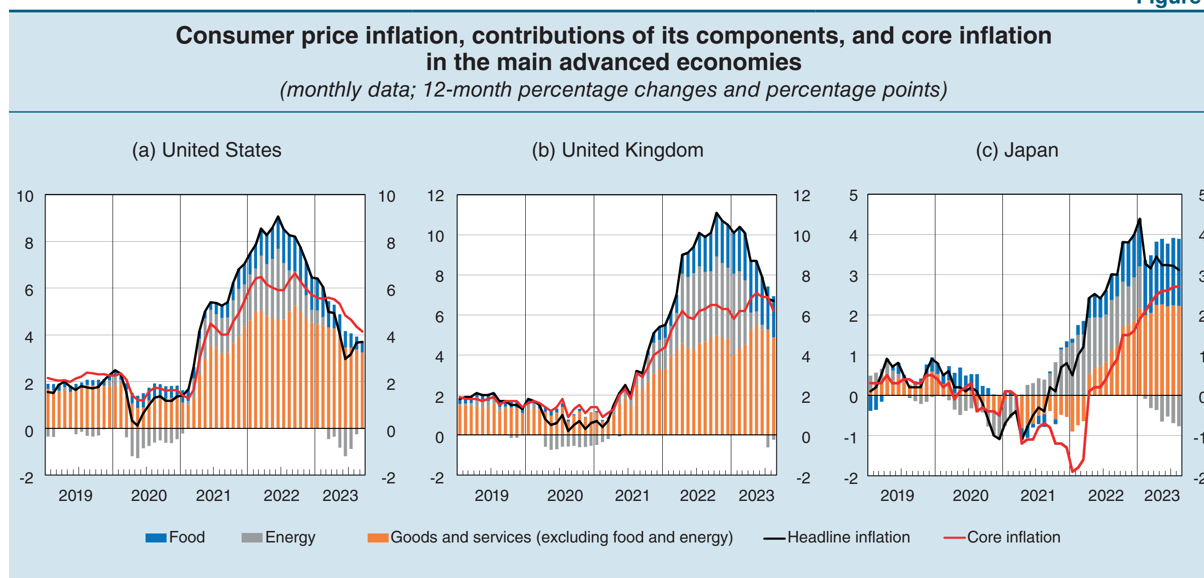
Over the year, falling energy commodity prices and monetary tightening have led to lower consumer price inflation in the United States and the United Kingdom, accompanied by a further decline in core inflation: to 4.1 per cent in September (from 4.3 per cent in August) in the United States (Figure 3.a), and to 6.2 per cent in August (from 6.9 per cent in July) in the United Kingdom (Figure 3.b). The decline in headline inflation in Japan was coupled with the stability of the core component (at 2.7 per cent in August; Figure 3.c).

The monetary policy stance remains tight in the United States and the United Kingdom

The Federal Reserve raised its policy rate by 25 basis points in July, bringing the federal funds target rate to between 5.25 and 5.50 per cent. In its August meeting, the Bank of England also raised its reference rate by 25 basis points, to 5.25 per cent. In September, both central banks left interest rates unchanged, but indicated that further increases could be decided; they also signalled that the monetary policy stance will remain tight for a period long enough to bring inflation back to target.

Figure 3

Consumer price inflation, contributions of its components, and core inflation in the main advanced economies
(monthly data; 12-month percentage changes and percentage points)



Source: Based on national statistics.

Over the summer, the Bank of Japan kept its reference rate unchanged, but it modified its yield curve control strategy by expanding the fluctuation band for ten-year bond yields, which previously stood at ±0,5 per cent, setting the upper bound at 1 per cent. This measure, motivated by the need for greater flexibility in monetary accommodation, and the central bank's statements concerning a possible discontinuation of the negative rate policy were interpreted by the markets as a first sign of the end of the expansionary phase. In China, monetary expansion was moderate overall; in order to limit the recessionary effects of the real estate crisis, priority was given to regulatory measures aimed at supporting activity in the sector.

1.2 THE EURO AREA

The cyclical weakness under way in the euro area since late 2022 continued in the summer, reflecting tighter financing conditions and the erosion of household income due to inflation. Consumer price growth slowed to 4.3 per cent in September, thanks to a decline across all the main components. In its mid-September meeting, the Governing Council of the European Central Bank raised its key interest rates by a further 25 basis points. The Council, which reiterated that it will continue to follow a data-dependent approach, believes that the key interest rates have reached levels that, maintained for a sufficiently long period, will make a substantial contribution to the timely return of inflation to target.

GDP edges up slightly in the second quarter ...

In the spring, GDP continued to grow marginally in the euro area compared with the previous period (Table 2).

Table 2

Euro-area GDP growth and inflation
(percentage changes)

	GDP growth			Inflation
	2022	2023 Q1 (1)	2023 Q2 (1)	2023 September (2)
France	2.5	0.0	0.5	(5.6)
Germany	1.8	-0.1	0.0	(4.3)
Italy	3.7	0.6	-0.4	(5.7)
Spain	5.5	0.5	0.4	(3.2)
Euro area	3.3	0.1	0.1	(4.3)

Sources: Based on national statistics and Eurostat data. The figures in brackets are preliminary estimates.
(1) Quarterly data adjusted for seasonal and calendar effects; percentage changes on previous period. – (2) Monthly data; year-on-year percentage changes in the harmonized index of consumer prices (HICP).

Household spending stagnated, while investments made a small positive contribution to GDP growth. Net external demand shaved 0.4 percentage points off GDP growth as a result of a fall in exports, while imports were broadly unchanged. Headcount employment and hours worked slowed. On the supply side, value added decreased across all main sectors except services, where the expansion lost momentum. Economic activity developed unevenly across the major countries: it grew in France and Spain, remained stable in Germany and declined in Italy.

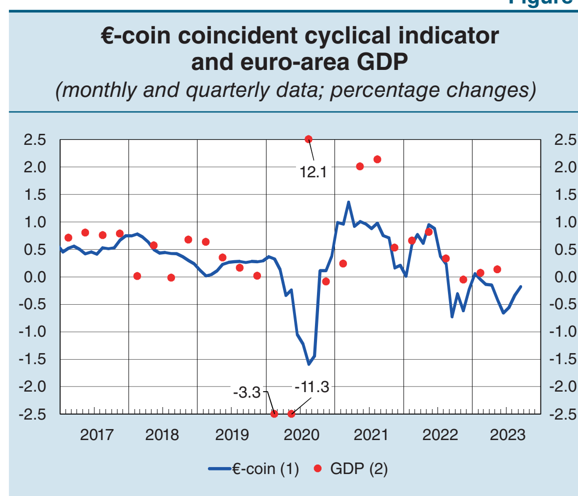
... then stagnates in the third quarter

The latest economic indicators suggest that GDP remained broadly unchanged during the summer months: the weakness in manufacturing activity was compounded by that in services. In July, industrial production dropped by 1.1 per cent on the previous month and the PMI for the manufacturing sector signals that the contraction continued in August and September; since August, the PMI for services has fallen below the threshold compatible with expansion for the first time in 2023. Signs of a deterioration stem from consumer surveys as well: according to the European Commission's surveys, consumer confidence has waned, reflecting more pessimistic expectations regarding both the general state of the economy and consumers' own financial situation. In September, the Bank of Italy's €-coin indicator, which gives an estimate of the underlying GDP trend in the euro area net of the most erratic components, picked up moderately, though it remained negative (Figure 4). In the summer, signs of a slowdown in employment emerged in the main euro-area countries. Nonetheless, the labour market remains resilient: in August the unemployment rate was virtually unchanged from the previous month, at 6.4 per cent.

Figure 4

€-coin coincident cyclical indicator and euro-area GDP

(monthly and quarterly data; percentage changes)



Sources: Bank of Italy and Eurostat.
(1) For €-coin, monthly estimates of changes in GDP on the previous quarter, net of the most erratic components. The last monthly estimates available are those for September 2023. The methodology used to construct the indicator and the updated data on the indicator are available on the Bank of Italy's website: 'Cyclical coincident indicator of the euro area economy(€-coin)'. – (2) For GDP, quarterly data; percentage changes on previous quarter.

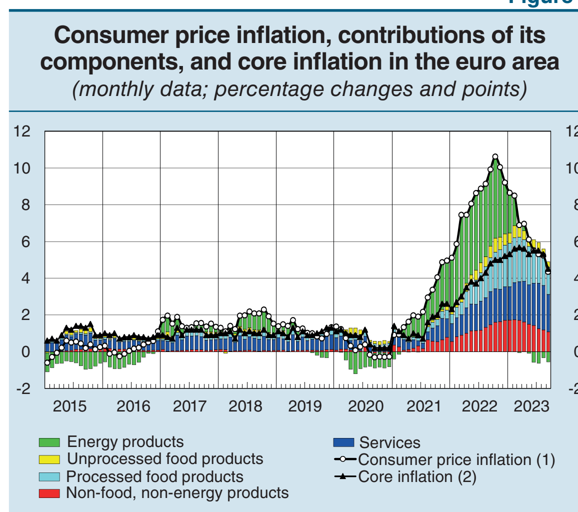
GDP growth projections are revised downwards

The ECB staff projections released in September[1] indicate that GDP growth will slow to 0.7 per cent in 2023, and then accelerate to 1.0 and 1.5 per cent in 2024 and 2025 respectively. Compared with last June's scenario, the projections have been revised downwards by 0.2 percentage points for 2023 and by 0.5 percentage points for 2024, mainly because of the marked tightening in financing conditions for households and firms.

Figure 5

Consumer price inflation, contributions of its components, and core inflation in the euro area

(monthly data; percentage changes and points)



Sources: Based on ECB and Eurostat data.
(1) 12-month percentage change in the HICP. – (2) 12-month percentage change in the HICP excluding energy and food.

1 For more information, see the ECB's website: 'ECB staff macroeconomic projections for the euro area', September 2023.

Inflation continues to fall

In September, consumer price inflation came to 4.3 per cent on an annual basis (Figure 5). Energy prices fell while food prices slowed. Core inflation decreased, though it remains high at 4.5 per cent; over the past few months, it has been driven by the acceleration in the price of some regulated components or of components that are typically linked to past inflation trends (such as communication, financial and insurance services, expenditure on education, pharmaceutical products and healthcare services, and rents). The results of a granular analysis of the persistence of inflationary pressures support the ECB staff's expectations of a downward trend in core inflation (see the box 'The heterogeneous developments of the components of euro-area core inflation').

THE HETEROGENEOUS DEVELOPMENTS OF THE COMPONENTS OF EURO-AREA CORE INFLATION

Core inflation, measured net of energy and processed and unprocessed food products, accounts for about 70 per cent of the overall HICP basket in the euro area. It has been rising since mid-2021, peaking at 5.7 per cent in March 2023, its highest value since the inception of the European monetary union. The availability of disaggregated data makes it possible to break down this trend into the different components of the HICP basket, which includes non-energy industrial goods and services, and to analyse the heterogeneity in price developments for those items, classifying them into three clusters based on when the price increases started.

Cluster 1 includes goods that recorded exceptional price increases as early as 2021: furnishings, household equipment and routine house maintenance, transport equipment, electronic devices, recreational equipment (panel (a) of Figure A). This cluster accounts for one third of the components of core inflation. The production of these industrial goods, which typically involves long supply chains, has experienced severe supply bottlenecks owing to shortages of intermediate inputs and commodities and longer delivery times during the pandemic (see the box: 'Supply chain bottlenecks: the impact on the global economy', in *Economic Bulletin*, 1, 2022).

Cluster 2, which comprises household maintenance services, vehicle transport and maintenance services, restaurant and catering services and some non-durable goods, recorded exceptional price hikes only starting in 2022 and until the first quarter of 2023. Price developments for these items, which also account for about one third of the core subcomponents, were affected by the increase in input costs and, above all, in energy prices (see the box 'The pass-through of energy price increases to consumer price inflation in Italy and the euro area', in *Economic Bulletin*, 1, 2023). The pick-up in the inflation of these components was also supported by the recovery in internal demand, fuelled by the easing of restrictions and the post-pandemic reopening of many contact intensive services.

Cluster 3, which includes the remaining core components, including housing rents, insurance and postal services, and social, medical and education services, has driven inflation upwards only during 2023. The prices of these items are sometimes regulated or tend to be adjusted on a one-off basis.

In the second and third quarter of 2023, while the goods and services in the first two clusters exhibited disinflation, upward pressures were observed for the third cluster, leading core inflation to essentially stabilize at levels above 5 per cent (see panel (b) of Figure A).

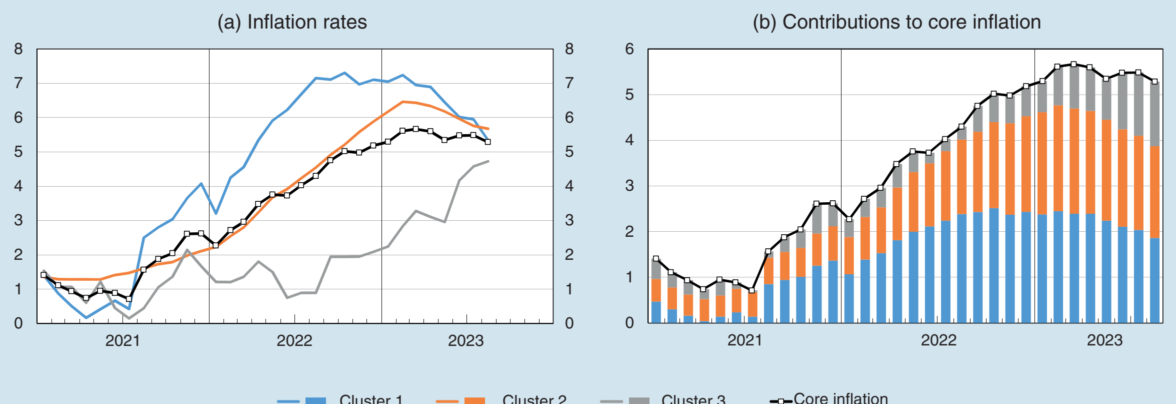
An econometric analysis makes it possible to look at a set of historically persistent components and combine this information with the item's contribution to the recent acceleration in inflation.[1] The results show that most of the components that were the main drivers of core inflation in 2021 and 2022

[1] In the analysis the components are selected based on the following three characteristics: (a) high historical persistence, to various degrees, of monthly price changes (the degree of persistence is estimated using univariate autoregressive models on a sample of changes from 2002 to 2023); (b) an inflation rate in 2022 greater or less than 4 per cent for that item; (c) a weight of that item above or below 1 per cent of the core basket.

Figure A

Core inflation and contributions of its components (1)

(12-month percentage changes and percentage points)



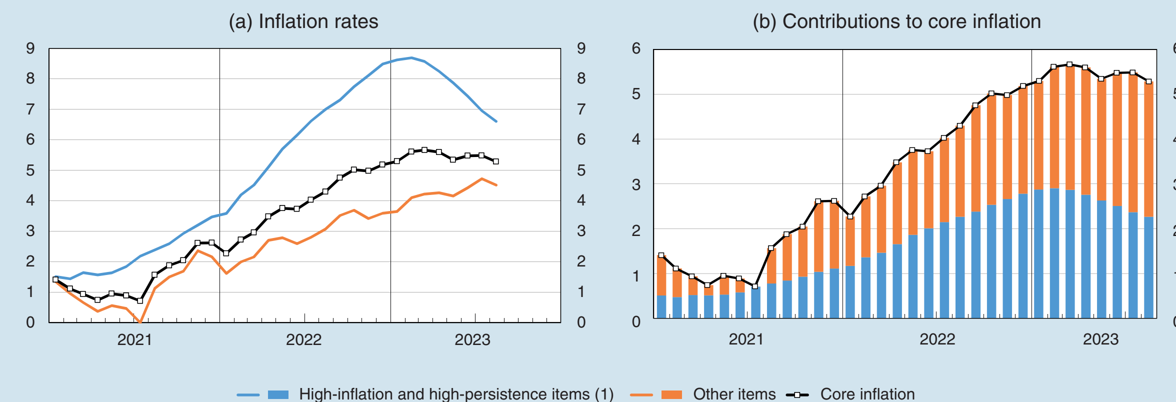
Source: Based on Eurostat data.
(1) The clusters are defined by the year in which they started registering marked increases: Cluster 1 as of 2021; Cluster 2 as of 2022; Cluster 3 as of 2023.

were also high-persistence components. Since the second quarter of 2023, a process of disinflation has been recorded for these items, i.e. mainly household goods and services, purchase and maintenance of motor vehicles, and some leisure goods and services (see panel (a) of Figure B). Among the remaining components, which instead registered lower inflation rates in 2021 and 2022, the upward pressures of the recent quarters stemmed from the items for which price changes are usually less persistent (see panel (b) of Figure B), including transport, education, medical and cultural services.

Figure B

Core inflation and contributions of its high-inflation and high-persistence components

(percentage points)



Source: Based on Eurostat data.
(1) For a description of the characteristics of the high-inflation and high-persistence components, see footnote 1 in the box.

The results of the disaggregated analysis support the forecast of a decline in core inflation over the coming quarters, as reported in the latest Eurosystem staff projections (June 2023) and ECB staff projections (September 2023). The downward trajectory would be driven by a steady slowdown in the price of high-persistence items, as well as by the unwinding of the most recent upward pressures, which, instead, should be of a more temporary nature.

Wage growth strengthens

In the second quarter, the growth rate of actual hourly wages accelerated in the euro area on average (to 5.8 per cent on an annual basis, from 5.3 per cent in the previous period), while that of contractual wages remained broadly stable (4.3 per cent against 4.4 per cent).[2] In the spring, unit labour costs rose significantly, also owing to the downturn in productivity levels.

Producer price pressures other than labour costs have eased further: in August, the producer price inflation of goods sold on the internal market stood at -11.5 per cent year-on-year, from -7.6 per cent in July; net of energy products, inflation was -0.3 per cent and has been on a downward path for more than a year.

Inflation projections are revised slightly upwards

The ECB staff projections released in September indicate that euro-area headline inflation is expected to decline to 5.6 per cent in 2023 on average, to 3.2 per cent in 2024 and to 2.1 per cent in 2025. These projections are 0.2 percentage points higher than those released in June for 2023 and 2024, owing to an upward revision for energy prices, and 0.1 percentage points lower for 2025. Core inflation is projected to reach 5.1 per cent in 2023, 2.9 per cent in 2024 and 2.2 per cent in 2025.

Firms' expectations regarding increases in selling prices become more muted

According to European Commission surveys, firms' expectations of an increase in their selling prices over the following three months continued to fade in the summer months, while those of households for changes in consumer prices over the following twelve months picked up again moderately. Similar indications emerge from the ECB's Consumer Expectations Survey published in August: households' expectations for inflation three years ahead increased slightly to 2.5 per cent, though they remain well below those reported in the second half of 2022.

Long-term inflation expectations as implied by the markets remain in line with the price stability objective

After increasing slightly during the summer, in early October the yields on inflation-linked swap (ILS) contracts over the two-year and five-year horizons returned close to early July levels in the euro area (2.4 per cent; Figure 6.a); they remained broadly unchanged at 2.5 per cent over the five-year, five years forward horizon. When measured net of the estimated inflation risk premium, they stood at 1.9 per cent, highlighting the anchoring of inflation expectations to the price stability objective. The experts interviewed in the Survey of Monetary Analysts (SMA), conducted by the ECB between 28 and 31 August, estimate that inflation is likely to return to close to 2 per cent early in 2025 (Figure 6.b). Based on option prices, the probability of inflation being between 1.5 and 2.5 per cent on average in the next five years has risen from 28 to 38 per cent, while that of an increase in prices of more than 2.5 per cent fell from 50 to 40 per cent (Figure 6.c).

The ECB Governing Council tightens monetary conditions further

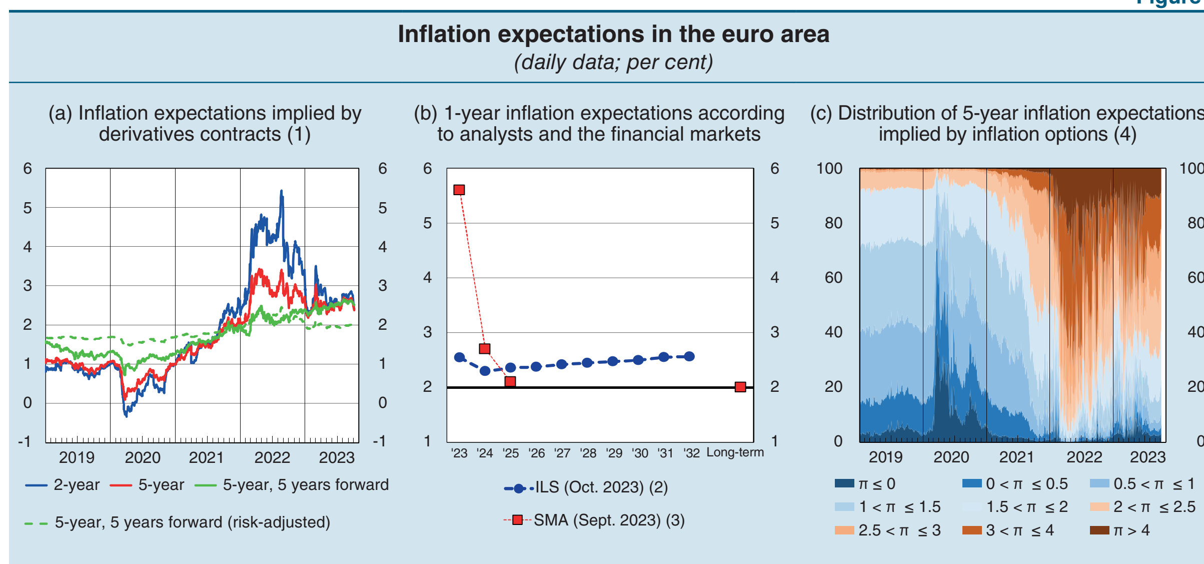
The ECB Governing Council raised its key interest rates by a total of 0.5 percentage points in its July and September meetings, bringing the overall increase in the Eurosystem's deposit facility rate to 4.00 per cent (Figure 7).[3] The Governing Council assessed that the past interest rate increases continue to be transmitted forcefully to financing conditions; inflation continues to decline but is still expected to remain too high for too long. Based on its current assessment of economic and financial data, the Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long period, will make a substantial contribution to the timely return of

[2] This figure includes one-off payments which, because they are temporary, boost workers' income without having a direct impact on medium-term labour cost trends.

[3] In an environment of ample liquidity, market rates are anchored to the deposit facility rate, which is the one relevant for the transmission of monetary policy impulses.

Figure 6

Inflation expectations in the euro area
(daily data; per cent)

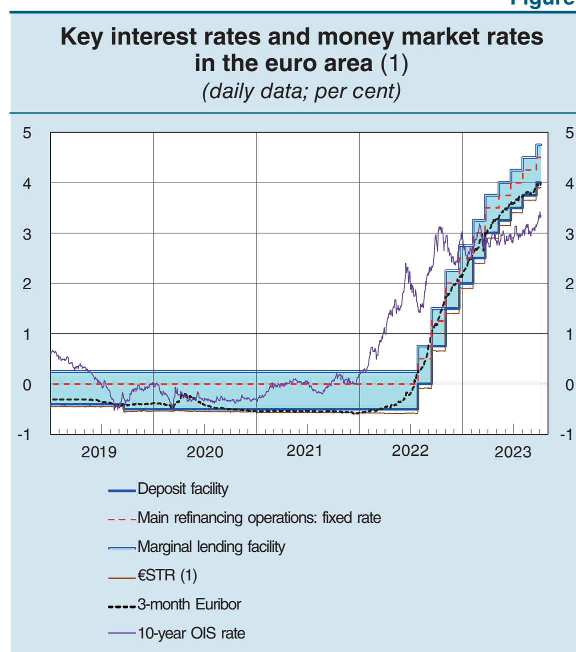


Sources: ECB and based on Bloomberg data.
(1) Expected inflation rates implied by 2-year, 5-year and 5-year, 5 years forward ILS contracts. For details on the model used to calculate the series over the 5-year, 5 years forward horizon adjusted for the inflation risk premium, see S. Cecchetti, A. Grasso and M. Pericoli, 'An analysis of objective inflation expectations and inflation risk premia', Banca d'Italia, Temi di Discussione (Working Papers), 1380, 2022. – (2) 1-year expected inflation rates implied by ILSs at various maturities. – (3) Median of the expectations of the respondents polled as part of the Survey of Monetary Analysts (SMA) conducted by the ECB from 28 to 31 August 2023. – (4) The distribution of expected inflation (π) is estimated based on the prices of zero-coupon inflation options in the euro area over a 5-year horizon. The underlying inflation rate is calculated based on the harmonized index of consumer prices excluding tobacco.

inflation to its 2 per cent target. Furthermore, the Governing Council reiterated that it will continue to follow a data-dependent approach to determining the appropriate level and duration of monetary tightening and that its future decisions will ensure that the key interest rates will be set at sufficiently restrictive levels for as long as necessary. In order to improve the efficiency of monetary policy, in its July meeting the Governing Council decided to set the remuneration of minimum reserves at 0 per cent, thus reducing the overall amount of interest that needs to be paid to banks on these reserves.

Figure 7

Key interest rates and money market rates in the euro area (1)
(daily data; per cent)



Sources: ECB and Refinitiv.
(1) As of 1 October 2019, the €STR is a new overnight benchmark rate for the euro-area money market. For the period prior to 1 October, the figure shows the pre-€STR.

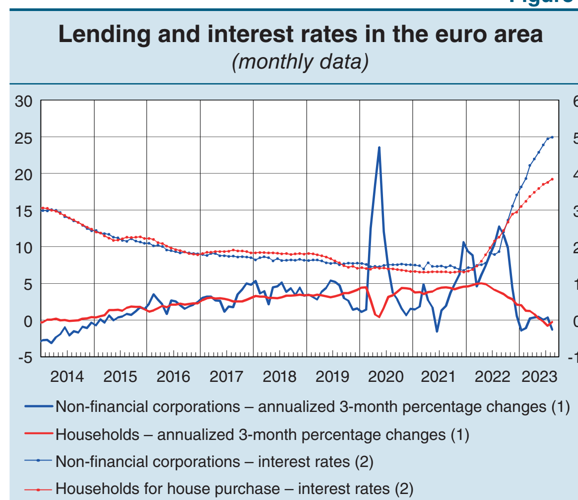
As of July, reinvestments under the asset purchase programme (APP) have been discontinued and the APP portfolio has declined by around €75 billion compared with the end of June. As concerns the pandemic emergency purchase programme (PEPP), the Governing Council reiterated that it intends to reinvest the principal payments from maturing securities purchased under the PEPP in a flexible way until at least the end of 2024. The total amount of funds disbursed with the third series of targeted longer-term refinancing operations (TLTRO III) and still held by the banking system equalled €491 billion for the euro area and €152 billion for Italy.

The cost of lending continues to rise ...

The past increases in key interest rates have continued to pass through to the cost of lending to firms and to households for house purchase, both of which have risen further. Between May and August, the interest rate on new loans to non-financial corporations went up by around 0.4 percentage points, to 5.0 per cent; the rate on new mortgage loans rose by 0.2 percentage points, to 3.8 per cent (Figure 8). Since the beginning of the monetary policy normalization phase, the average rate on outstanding loans has increased by 2.1 percentage points for firms (to 3.7 per cent in August) and by 0.7 percentage points for mortgage loans (to 2.3 per cent).

Figure 8

Lending and interest rates in the euro area
(monthly data)



Source: ECB.
(1) Includes bad debts, repos and loans not reported in banks' balance sheets because they have been securitized. The percentage changes are net of reclassifications, exchange rate variations, value adjustments, and other variations not due to transactions. Data are seasonally adjusted. – (2) Average of interest rates on new short-, medium-, and long-term loans weighted using the 24-month moving average of new loan disbursements; for non-financial corporations, includes overdrafts. Right-hand scale.

... contributing to a further weakening in credit growth

Growth in lending to firms weakened further, reflecting, on the one hand, higher lending rates and firms' reduced need for credit owing to sluggish economic activity and, on the other hand, the tightening of banks' credit standards. In August, growth in bank lending to non-financial corporations, calculated on a three-month and seasonally-adjusted annualized basis, turned negative for the euro area as a whole (-1.3 per cent, from 0.5 per cent in May). Loans to firms have started to contract in Germany; the decline under way since May has continued in Spain and sharpened in Italy. Conversely, only in France have loans accelerated. Lending to euro-area households has also started to shrink (by 0.3 per cent, down from a positive growth of 0.3 per cent in May), following the slowdown registered in France and Germany and the more marked credit contraction in Italy; the reduction in lending continued at an unchanged pace in Spain.

Annual M3 growth in the euro area, which had turned negative in June, stood at -1.3 per cent in August, the lowest rate since the beginning of the EMU. As of the beginning of 2021, the weakening of monetary dynamics has been affected by developments in the monetary aggregate M1 (-10.4 per cent in August), driven by the slowdown and eventually by the contraction in sight deposits; the reduction in sight deposits has been only partially offset, after July 2022, by the increase in fixed-term deposits.[4] These developments reflect weak credit dynamics (which mechanically dampen the creation of money associated with the disbursement of loans), a shrinking Eurosystem's balance sheet and, more recently, the rebalancing of banks' liabilities towards medium- and long-term items not included in M3.[5]

The implementation of the national recovery and resilience plans continues

Since 10 July, 13 countries have submitted a request to amend their National Recovery and Resilience Plans, including a new chapter of measures under the European programme REPowerEU.[6] In the same period, new funds amounting to €21 billion have been disbursed via the Recovery and Resilience Facility, of

[4] The limited pass-through of the increases in key interest rates to the return on sight deposits is contributing to the rebalancing of banks' liabilities towards longer-term items and to an increase in households' demand for government bonds, unlike the return on other types of deposits to which the rises in key interest rates are being transmitted more markedly.
[5] The rebalancing is also likely linked to the effect of TLTRO III repayments on banks' funding.
[6] These are Austria, Belgium, Cyprus, Croatia, Finland, Greece, Italy, Latvia, Poland, Romania, Slovenia, Sweden and Hungary; last July, the EU Council approved the requests of amendment previously submitted by France, Malta and Slovakia.

which €18.5 billion to Italy (see Section 2.9). Since the launch of the programme, the Commission has distributed nearly €175 billion among the various EU member states.

Over the past three months, also with a view to financing the initiatives in the plans, the Commission has issued over €27 billion in bonds; the average yield at issue for bonds with a maturity of up to six months and for those with a maturity between three and 30 years stood at 3.7 and 3.5 per cent respectively. Overall, the bonds issued by the Commission (under all its programmes) and outstanding as at 10 October amounted to nearly €445 billion.

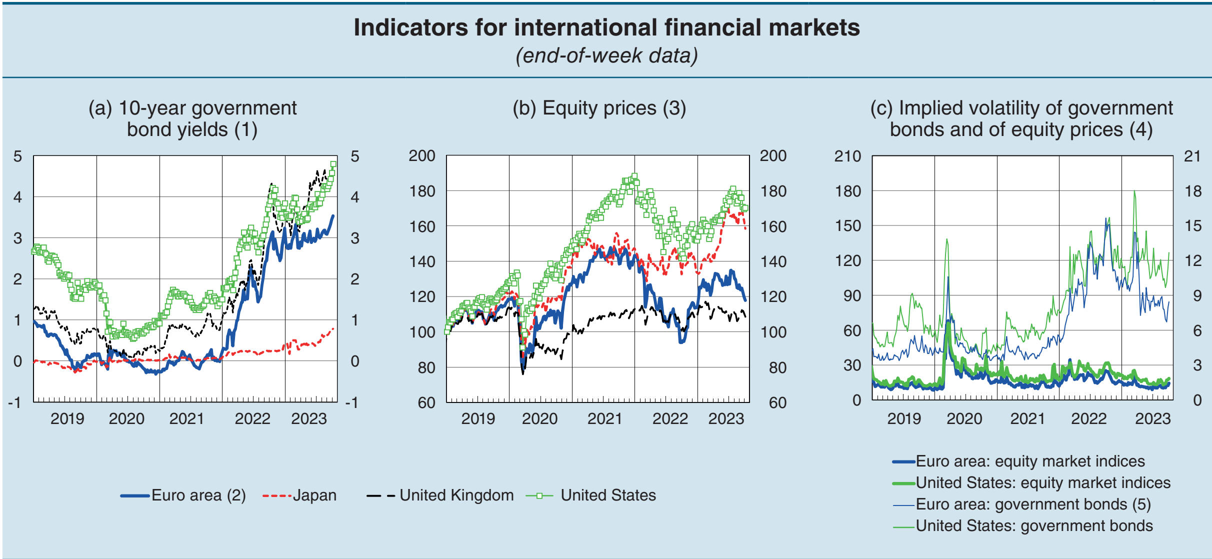
1.3 INTERNATIONAL FINANCIAL MARKETS

International financial market conditions tightened in the third quarter, reflecting the revision of investors' expectations of a rapid easing of monetary policy. Government bond yields increased in the leading advanced economies, more markedly in the United States; equity prices decreased. Implied volatility in the equity markets remains low, while it continues to stand at high levels in the bond markets. The euro depreciated against the US dollar.

Financial market conditions worsen in the summer months

In the third quarter, the yields on long-term government bonds increased in the leading advanced economies, more markedly in the United States (Figure 9.a). These increases reflected the revision of investors' expectations of a rapid easing of monetary policy. The rise in US Treasury yields was also affected by expectations of an increase in the federal deficit and a reduction in the Federal Reserve's securities holdings. In Japan, the ten-year bond yield increased after the central bank raised the upper bound of the fluctuation band (see Section 1.1). In the same period, the increase in equity prices observed in the first half of the year came to a halt in all the leading advanced economies, as a result of higher interest rates and worsened global growth prospects (Figure 9.b). Implied volatility remains low in the equity markets

Figure 9



Source: Refinitiv.
(1) Per cent. – (2) For the yields on 10-year government bonds: average yields, weighted by 2022 GDP at chain-linked prices, on the 10-year benchmark government securities of the euro-area countries (excluding Cyprus, Croatia, Estonia, Greece, Latvia, Lithuania, Luxembourg, Malta, Slovakia and Slovenia). – (3) Indices: 1st week of January 2019=100. Equity indices: Datastream for the euro area, Nikkei 225 for Japan, FTSE All Share for the United Kingdom and Standard & Poor's 500 for the United States. – (4) Percentage points. Government bonds: volatility implied by the prices of options on futures on the German Bund for the euro area and on the Treasury Note for the United States (MOVE index). Equity indices: volatility implied by the prices of options on STOXX Europe 600 for the euro area and Standard & Poor's 500 for the United States. – (5) Right-hand scale.

and high in the sovereign bond markets, which are affected by the uncertainty about the future stance of monetary policy (Figure 9.c).

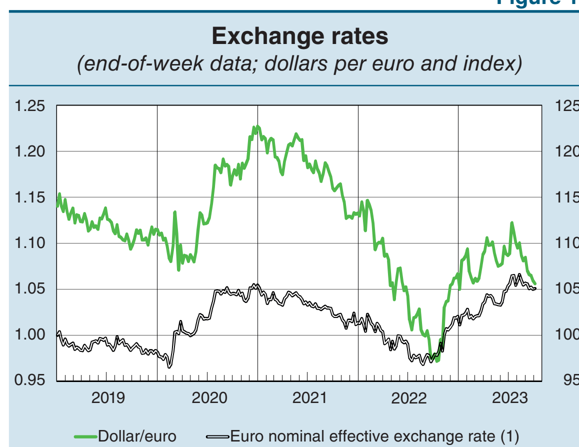
The euro weakens against the dollar

Between the end of June and the beginning of October, the euro depreciated against the dollar as a result of better growth prospects in the US than in the euro area and of a wider spread between interest rates, especially on medium- and long-term maturities. Conversely, the nominal effective exchange rate of the euro against the currencies of the euro area's 41 major trading partners remained broadly unchanged (Figure 10). The yen continued to depreciate against the US dollar, reflecting the Bank of Japan's more accommodative monetary policy, while it remained stable against the euro. As a result of the outflows of foreign capital from the Chinese bond and equity markets, the renminbi continued to depreciate against the dollar, prompting the People's Bank of China to intervene in support of the currency.

Figure 10

Exchange rates

(end-of-week data; dollars per euro and index)



Sources: ECB and Refinitiv.
(1) Index: 1st week of January 2019=100. Right-hand scale. An increase in the index corresponds to an appreciation of the euro.

2 THE ITALIAN ECONOMY

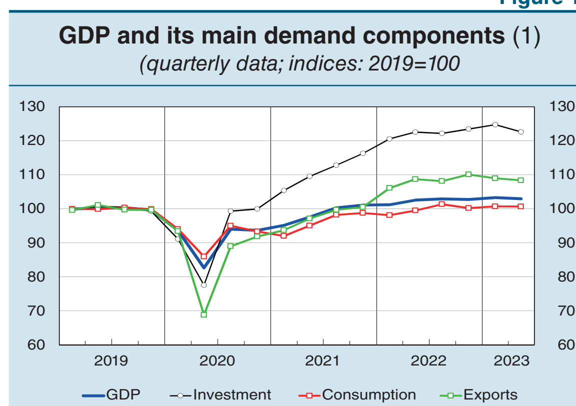
2.1 CYCLICAL DEVELOPMENTS

In Italy, the cyclical phase has recently been showing marked volatility. Following a considerable rise in the first quarter, GDP contracted in the second quarter, as value added in industry declined and expansion in services ceased after a period of almost uninterrupted growth since the spring of 2021, when businesses gradually reopened after the pandemic crisis. In the third quarter, the sluggishness in manufacturing and in the services sector seems to have continued.

GDP falls in the spring ... The sharp increase in GDP in the first quarter was largely offset by the fall in the second quarter, which was greater than expected (Figure 11 and Table 3). Over the spring months, household consumption slowed, in a context of labour market resilience and stagnating disposable income. Fixed investment expenditure fell again, after a long phase of expansion, but is still nearly 25 per cent higher than its pre-pandemic levels;[1] this decline was due to the construction component, which was affected, especially in the housing sector, by the lesser impulse coming from fiscal support measures. The contribution of foreign trade was slightly negative, owing to the decline in exports, as a reflection of deteriorating global demand (see Section 2.4), and to stationary imports. On the supply side, value added decreased in all sectors: significantly so in

Figure 11

GDP and its main demand components (1)
(quarterly data; indices: 2019=100)



Source: Based on Istat data.
(1) Chain-linked volumes; data seasonally and calendar adjusted.

Table 3

GDP and its main components (1)
(percentage change on previous period and percentage points)

	2022		2023		2022
	Q3	Q4	Q1	Q2	
GDP	0.3	-0.2	0.6	-0.4	3.7
Imports	2.1	-2.0	1.0	0.0	12.4
National demand (2)	1.2	-1.4	1.3	-0.2	4.3
National consumption	1.8	-1.1	0.5	0.0	3.9
Household spending (3)	2.5	-1.7	0.6	0.2	5.0
Gen. gov. spending (4)	-0.1	0.6	0.3	-0.8	0.7
Gross fixed investment	-0.3	1.0	1.0	-1.7	9.7
Construction	-2.9	0.9	0.4	-3.3	11.4
Capital goods (5)	2.4	1.2	1.7	-0.1	8.1
Change in stocks (6)	-0.1	-0.8	0.8	0.3	-0.7
Exports	-0.5	1.8	-1.0	-0.6	9.9
Net exports (7)	-0.9	1.3	-0.8	-0.2	-0.5

Source: Istat
(1) Chain-linked volumes; the quarterly data are seasonally and calendar adjusted. – (2) Includes the change in stocks and valuables. – (3) Includes non-profit institutions serving households. – (4) General government spending. – (5) Include investment in plants, machinery and arms (which also comprise transport equipment), cultivated biological resources and intellectual property. – (6) Includes valuables; contributions to GDP growth on previous period; percentage points. – (7) Difference between exports and imports; contributions to GDP growth on previous period; percentage points.

[1] Based on the version of Istat's national accounts released in September and October, GDP growth in terms of volumes was revised upwards by 1.3 percentage points (to 8.3 per cent) for 2021, whereas it was confirmed at 3.7 per cent for 2022 (for more details, see Istat's Annual National Accounts - Years 2020-2022, 'Gross domestic product and general government net borrowing', Flash Statistics, 22 September 2023). The figure for the cumulative growth in fixed investment expenditure between the end of 2019 and the second quarter of 2023 was revised upwards by 3.5 percentage points.

agriculture and construction, and to a lesser extent in industry excluding construction and only marginally in services.

... and the cycle remains weak in the third quarter

Based on our estimates, the cyclical phase was weak in the third quarter. While economic activity was sluggish in industry excluding construction and in services, there were signs of greater resilience compared with the previous quarter for value added in construction. On the demand side, GDP performance appears to have reflected broadly stationary levels of consumption and declining investment, partly as an effect of tightening financing conditions (see Section 2.7). In September, the Ita-coin indicator remained negative, confirming the underlying weakness of GDP that started in the second half of last year.

2.2 FIRMS

Industrial production appears to have stopped declining in the third quarter, a tendency that had been under way since mid-2022; however, our surveys and qualitative indicators continue to signal widespread weakness in manufacturing. Value added in services seems to have stagnated somewhat for the second consecutive quarter, indicating that the strong recovery that followed the most acute phase of the pandemic, when businesses reopened, is at an end.

Industrial activity stops declining

Industrial production grew in August by 0.2 per cent, from -0.9 per cent in July (Figure 12). In the quarter ending in that month, almost 60 per cent of the industrial sectors, which account for around half of industrial output, showed evidence of a decline on the previous quarter (Figure 13). The weakness in manufacturing activity is still attributable to the more energy-intensive sectors, whose production levels are still far below pre-pandemic levels (see the

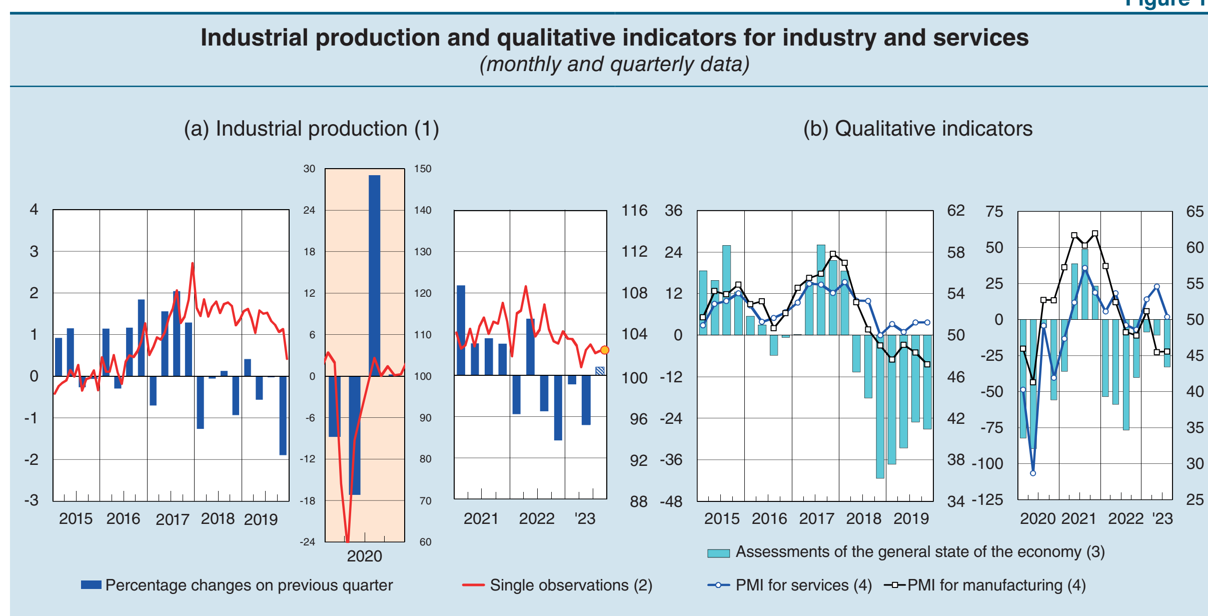


Figure 12

Industrial production and qualitative indicators for industry and services
(monthly and quarterly data)

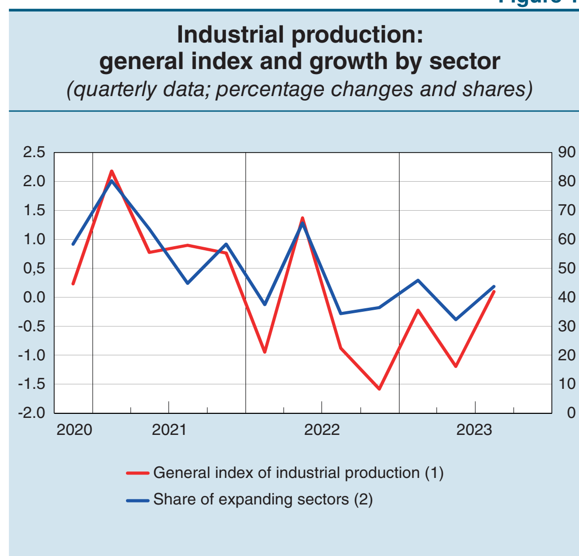
Sources: Based on data from the Bank of Italy, Istat, Markit and Terna.
(1) Data adjusted for seasonal and calendar effects. The yellow dot represents the forecast for September 2023, the striped bar represents the forecast for the third quarter. For visual layout reasons, the scale used for plotting the data for 2020 is different from that used for the other years. – (2) Monthly data. Index: 2015=100, right-hand scale. – (3) Quarterly data. Balance, in percentage points, of the responses 'better' and 'worse' to the question on the general state of the economy (see 'Survey on Inflation and Growth Expectations', Banca d'Italia, Statistics Series, 10 October 2023). – (4) Average quarterly data. Diffusion indices for economic activity in the sector. Right-hand scale.

box 'Energy price increases and recent developments in prices and production in the Italian manufacturing sector', in *Economic Bulletin*, 2, 2023).

Based on our estimates for September – which incorporate high-frequency data on electricity and gas consumption and on motorway traffic as well as qualitative indicators – industrial production appears to have edged up slightly on average in the summer months. However, the continued weakness in the global production cycle (see Section 1.1), and particularly in Germany, where the cycle is more significantly held back by the drop in intermediate goods production (as it is in Italy), still appears to weigh on manufacturing activity. This is also confirmed by the opinions gathered through a half-yearly survey of the regional economic situation conducted by the Bank of Italy's branches among firms, trade associations and financial intermediaries; the surveys show that logistics services too are being slightly negatively affected, especially in the northern regions of Italy.

Figure 13

Industrial production: general index and growth by sector
(quarterly data; percentage changes and shares)



Source: Based on Istat data.
(1) The industrial production figure for the third quarter of 2023 is calculated assuming zero per cent growth in September on the previous month. – (2) The sectors (as per Ateco classification) with growing production compared with the previous quarter are regarded as expanding. The Q3 2023 figure is calculated by comparing the quarter ending in August with the one ending in May. Right-hand scale.

Our business surveys signal widespread deterioration in confidence

In the third quarter, Istat's business confidence survey indicates a further worsening in the manufacturing sector, back to the levels of early 2021, and a weakening in the services sector; expectations for orders deteriorated. The confidence of construction firms, instead, remains stable at high levels. The surveys conducted by the Bank of Italy between August and September[2] indicate that firms' assessments of the state of the economy deteriorated sharply, as did firms' pessimism about their business situation. Manufacturing PMIs are still below the values compatible with economic expansion, although they have risen somewhat from their June lows; the indices for the service sector suggest substantial stability in their levels of activity.

Capital accumulation seemingly drops further over the summer

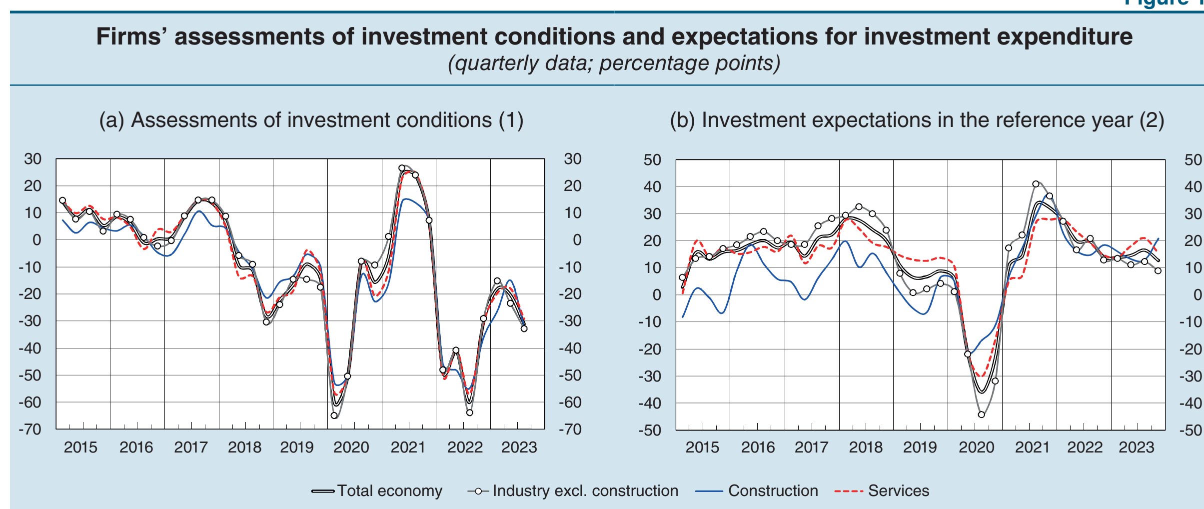
Investment fell in the second quarter (-1.7 per cent, from 1.0 per cent in the first), essentially as a consequence of falling investment in construction (at comparable rates in housing and other construction); expenditure on capital goods remained stable overall, despite the further recovery in expenditure on transport equipment, which returned to pre-pandemic levels. Data from Assilea, the Italian leasing association, on the value of leasing contracts for the financing of industrial vehicles and capital goods indicate that capital accumulation largely came to a halt in the summer months compared with the previous quarter. The firms surveyed by the Bank of Italy are still pessimistic about investment conditions across all sectors. They also anticipate a slowdown in nominal investment expenditure for the current year as a whole (Figure 14), owing partly to difficulties in accessing credit (see Section 2.7). The continuing expectations of growing investment expenditure, however, are in some measure sustained by the incentives provided for in the National Recovery and Resilience Plan (NRRP), which benefited about 30 per cent of firms in the first nine months of 2023.[3] According to

[2] For more details, see 'Survey on Inflation and Growth Expectations', Banca d'Italia, Statistics Series, 10 October 2023.
[3] For more details, see the 'Business Outlook Survey of Industrial and Service Firms', Banca d'Italia, Statistics Series, forthcoming.

the Bank of Italy's surveys, in the construction sector the benefits connected with the 'Superbonus' are going to gradually fade out, partly offset by the boost stemming from the incentives in the public works segment.

Figure 14

Firms' assessments of investment conditions and expectations for investment expenditure
(quarterly data; percentage points)



Source: 'Survey on Inflation and Growth Expectations', Banca d'Italia, Statistics Series, 10 October 2023.
(1) Balance of opinion between positive and negative assessments compared with the previous quarter. – (2) Balance between increase and decrease expectations compared with the previous year. The first expectations for the reference year are surveyed in the fourth quarter of the preceding year.

Firms' debt as a share of GDP decreases further

In the second quarter, the slowdown in gross fixed investment led to lower recourse to sources of internal financing by firms. Thus, internal financing sources expanded slightly, with sight deposits standing out at historically high levels. Over the same period, recourse to external financing sources, represented by overall nominal debt, remained practically unchanged compared with the previous quarter, whereas it diminished slightly as a percentage of GDP (to 66 per cent). The total debt of firms as a share of GDP continues to remain significantly lower than the euro area average of 99 per cent.

2.3 HOUSEHOLDS

Household consumption slowed down in the spring, reflecting the limited growth in purchasing power. The latest economic indicators suggest that overall household spending is weak in the third quarter too, especially for goods and to a lesser extent for services. The real estate market is affected by rising mortgage costs.

Household consumption slows in the second quarter

Over the spring months, household expenditure grew by a mere 0.2 per cent in real terms, down from 0.6 per cent in the first quarter. The growth in consumption for services was offset by a fall in purchases for all goods (durable, non-durable and semi-durable). Despite labour market conditions still being favourable overall (see Section 2.5), household consumption was dampened by stagnating real disposable income (-0.2 per cent on the previous quarter). A pilot survey of around 1,900 households conducted by the Bank of Italy between August and September indicates that the share of households that reported at least some difficulties in meeting monthly expenses increased in the first part of 2023 compared with 2022 as a whole.

Households incline towards caution in their use of savings

In the second quarter, the propensity to save fell to 6.3 per cent (down from 6.7 in the first quarter; Figure 15). The same survey indicates that only one fifth of the households who reported at least some difficulties in meeting monthly

expenses said they had managed to make savings between January and July. Among the households who deemed their income to be adequate, two thirds reported that they had made savings during the same period and that their prevailing intent is to hold the savings accumulated in recent years in deposits or invest them in other financial instruments; this suggests that the support to consumption stemming from the substantial amount of financial resources accumulated during the health crisis will be limited.[4]

Consumption remains feeble in the summer

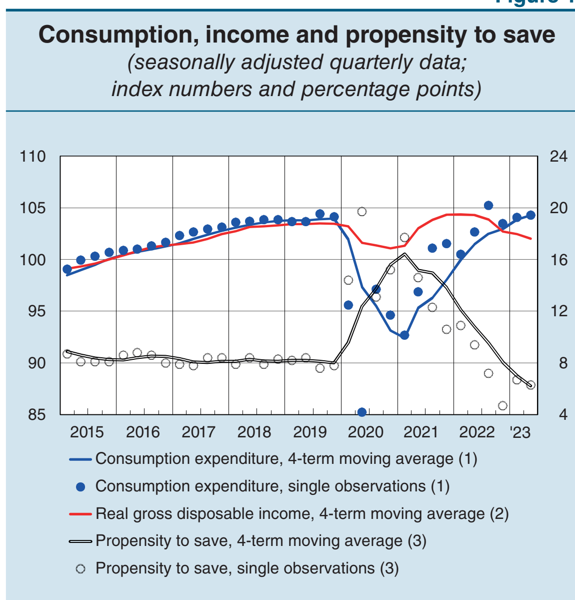
Based on our assessments, household spending remained steady in the third quarter. Confcommercio's consumption indicator points to an increase in expenditure on services in July and August, against stationary goods purchases, while car registrations also stopped rising in the same period. Over the summer months, there were fewer withdrawals and electronic payments, measured in real terms, compared with the previous quarter, and consumer confidence continued to deteriorate on average over the quarter, reflecting a worsening in the expectations regarding the general state of the economy as well as of individual finances (Figure 16). About two thirds of households in our pilot survey stated that they intended to increase overall spending over the next twelve months; on the other hand, a substantial proportion of the more financially vulnerable households expect to reduce consumption, especially for the purchase of tourism and leisure services and of durable goods.

Tighter financing conditions weigh on the real estate market

In the second quarter, house prices slowed further (to 0.7 per cent year-on-year) and sales went down again (Figure 17). According to the Italian Housing Market Survey conducted in June and July, real estate agent expectations remain unfavourable, anticipating a fall in house prices; conversely, they report current and expected rents to be on the rise. Demand remains weak, as in the previous six quarters, owing to difficulties in

Figure 15

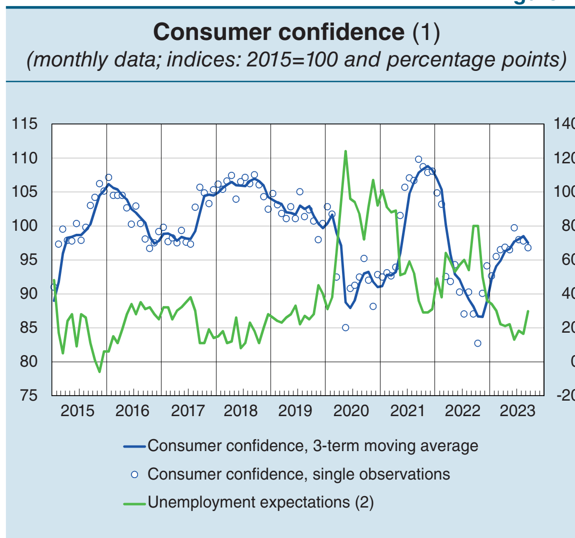
Consumption, income and propensity to save
(seasonally adjusted quarterly data; index numbers and percentage points)



Source: Based on Istat data.
(1) Chain-linked volumes; index: 2015=100. – (2) Net of the variation in the final consumption expenditure deflator for resident households; index: 2015=100. – (3) Consumer households' savings as a percentage of gross disposable income; per cent; right-hand scale.

Figure 16

Consumer confidence (1)
(monthly data; indices: 2015=100 and percentage points)



Source: Based on Istat data.
(1) Seasonally adjusted data. In the absence of the figure for April 2020, which was not recorded owing to the pandemic, the moving average for the quarters ending respectively in April, May and June 2020 is constructed on the basis of the two observations available. – (2) Balance in percentage points between the replies indicating 'an increase' and those indicating 'a decrease'. A rise in the balance signals a deterioration in the expectations regarding the unemployment rate. Right-hand scale.

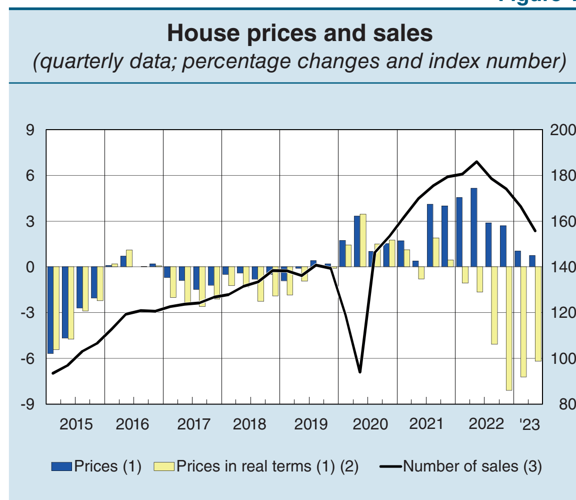
[4] For further details, see A. Colabella, E. Guglielminetti and C. Rondinelli, 'The distribution and use of Italian households' savings after the pandemic', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 797, 2023.

obtaining mortgages (which have reached their highest levels since the end of 2014) and to the rise in the associated costs (see Section 2.7). The most recent data derived from the Immobiliare.it online platform show that the number of listings taken down has stopped falling, suggesting a pick-up in sales going forward.

Figure 17

House prices and sales

(quarterly data; percentage changes and index number)



Sources: Based on data from the Bank of Italy, Istat and the Italian Revenue Agency's Osservatorio del mercato immobiliare (OMI).
(1) Year-on-year percentage changes. – (2) House prices deflated by the consumer price index. – (3) Adjusted for seasonal and calendar effects. Index: 2015=100. Right-hand scale.

The increase in market rates contributed to a higher ratio of total interest payments to household debt in the second quarter. On the other hand, overall debt servicing costs (interest plus repayment of principal) as a share of disposable income went down from 10.5 to 10.3 per cent, because of increased disposable income and reduced repayment of principal by households. Compared with the first quarter of the year, the ratio of Italian household debt to gross disposable income decreased to 60 per cent (91 per cent in the euro area). The 1 percentage point reduction was mainly due to the growth in disposable income, against a more limited decrease in nominal debt, especially in the short-term bank loan component. Household debt as a share of GDP also fell, reaching 39.6 per cent, against 55 per cent in the euro area.

2.4 FOREIGN TRADE AND THE BALANCE OF PAYMENTS

Export volumes of goods contracted again in the second quarter, reflecting the slowdown in global trade and the lack of momentum in economic activity in the euro area. Exports remained weak in the summer. The current account balance improved slightly in the spring owing to the reduction in the energy deficit. Non-resident investors made net purchases of Italian public and private securities. The TARGET2 negative balance improved. The positive net international investment position increased.

Exports decrease in the second quarter

Export volumes fell by 0.6 per cent in the spring, owing to a drop in the goods component, which more than offset the increase in exports of services (Table 4). Sales of goods declined in both euro-area and non-euro area markets, reflecting the slowdown in global trade and the decline in exports to major euro-area countries. Significant contributory factors were the decrease in the sales of refined oil products and, to a lesser extent, of chemical and mechanical products.

Import volumes remained stable. An increase in imports of services offset lower purchases of goods, mostly from euro-area countries. The largest contraction was recorded in the pharmaceutical sector.

Table 4

Italy's imports and exports (1)

(percentage changes on previous period)

	2022	2022		2023	
		Q3	Q4	Q1	Q2
Exports	**9.9**	**-0.5**	**1.8**	**-1.0**	**-0.6**
Goods	**6.1**	**-0.6**	**1.4**	**-1.8**	**-1.1**
to euro-area markets	7.2	-2.2	1.9	-1.9	-0.8
to non-euro area markets (2)	5.3	0.7	1.0	-1.7	-1.3
Services	**31.5**	**-0.3**	**3.6**	**2.8**	**2.0**
Imports	**12.4**	**2.1**	**-2.0**	**1.0**	**0.0**
Goods	**9.2**	**2.1**	**-2.7**	**0.1**	**-0.4**
from euro-area markets	6.8	-1.1	1.7	4.3	-3.2
from non-euro area markets (2)	11.5	5.0	-6.4	-3.7	2.3
Services	**27.2**	**1.9**	**0.9**	**5.2**	**1.9**

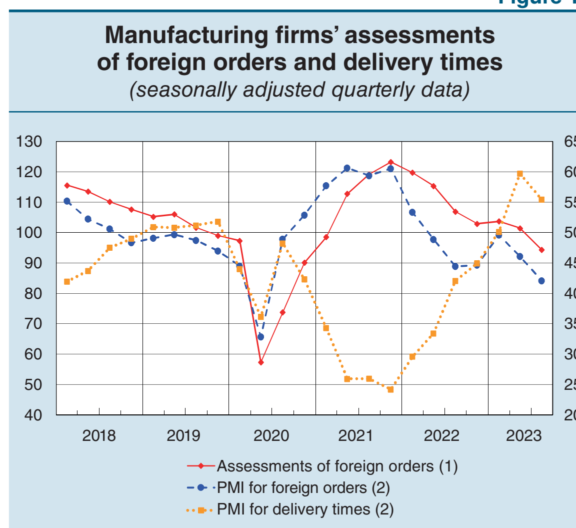
Sources: Based on Istat's national accounts and foreign trade data.
(1) Chain-linked volumes; raw annual data; quarterly data adjusted for seasonal and calendar effects. – (2) Includes unspecified countries and territories and, for exports, goods procured in Italian ports by foreign carriers.

Exports remain weak in the summer months

According to our estimates, exports of goods in volume declined in July compared with the average for the previous quarter, and imports fell even more sharply. Sales of goods to non-EU markets increased in August, driven in particular by shipbuilding deliveries. The manufacturing firms' assessments of foreign orders, as recorded by Istat, and the corresponding PMI are consistent with a significant weakening of foreign demand. There was a clear improvement in the delivery times of goods, indicating that supply difficulties are gradually – although not yet permanently – being overcome (Figure 18). Export price competitiveness declined slightly in the second quarter compared with the first three months of 2023.

Figure 18

Manufacturing firms' assessments of foreign orders and delivery times
(seasonally adjusted quarterly data)



Sources: Istat, Markit and Refinitiv.
(1) Quarterly average based on Istat's monthly survey of firms; percentage balance of replies of 'increasing' or 'decreasing' foreign orders, minus the average since the start of the time series (January 2000) plus 100. Q2 2020 is the average of two months; no data were gathered in April due to the pandemic emergency. – (2) Diffusion index. Quarterly average. Right-hand scale.

The current account balance improves slightly in the second quarter

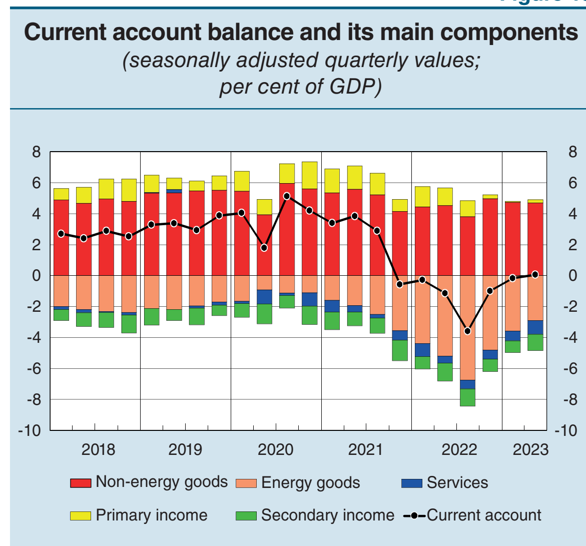
In seasonally adjusted terms, the current account was close to a balance in the spring, standing at 0.1 per cent of GDP (compared with -0.2 per cent in the previous quarter; Figure 19). The decrease in the energy deficit, mainly reflecting lower prices, especially for natural gas, contributed to this. The primary income surplus was stable, but remained significantly lower than the 2022 average, and was especially impacted by the investment income balance, which was affected by rising interest rates.

Non-resident investors make net purchases of Italian securities ...

In the second quarter, the financial account balance was positive at €10.9 billion (-€8.3 billion in the previous quarter; Table 5). The increase in net portfolio liabilities, due to strong growth in foreign investment in Italian securities, was

Figure 19

Current account balance and its main components
(seasonally adjusted quarterly values; per cent of GDP)



Source: For GDP, Istat.

Table 5

Balance of payments
(billions of euros)

	2022	2022		2023	
		Q3	Q4	Q1	Q2
Current account	**-28.5**	**-11.7**	**-0.3**	**-8.7**	**-2.0**
Seasonally adjusted		-17.5	-4.9	-0.9	0.3
Memorandum item:					
% of GDP (1)	-1.5	-3.6	-1.0	-0.2	0.1
Capital account	**10.7**	**2.3**	**5.3**	**3.2**	**1.1**
Financial account	**-6.8**	**-11.2**	**19.9**	**-8.3**	**10.9**
Direct investment	-14.8	9.0	-15.1	4.7	-6.6
Portfolio investment	162.3	30.9	36.2	18.8	-26.0
Derivatives	11.4	7.6	8.1	-0.9	-0.1
Other investment (2)	-167.6	-59.0	-10.9	-31.4	41.8
Changes in official reserves	2.0	0.3	1.5	0.5	1.8
Errors and omissions	**11.0**	**-1.8**	**14.8**	**-2.8**	**11.8**

(1) The annual figure for 2022 refers to the non-seasonally adjusted current account balance. – (2) Includes change in the TARGET2 balance.

more than offset by the decrease in the TARGET2 negative balance in other investments. In July, the financial account recorded a positive balance of €18.8 billion, driven by a further drop in the TARGET2 negative balance.

Between April and June, foreign investors, especially euro-area investment funds, showed a keen interest in Italian securities, making purchases for €45.2 billion (€4.0 billion between January and March). The purchases were almost entirely concentrated in bonds (of which €34.0 billion in government securities), probably driven by positive net issues and increased yields. Foreign direct investment also accelerated, with an inflow of €13.4 billion, largely attributable to intra-company loans.

In the same period, investments by residents in foreign portfolio assets amounted to €19.2 billion and the rebalancing of instruments towards debt securities continued in the wake of rising bond yields. Most purchases can be attributed to the banking sector, which also increased net funding abroad in loans and deposits by €45.6 billion.

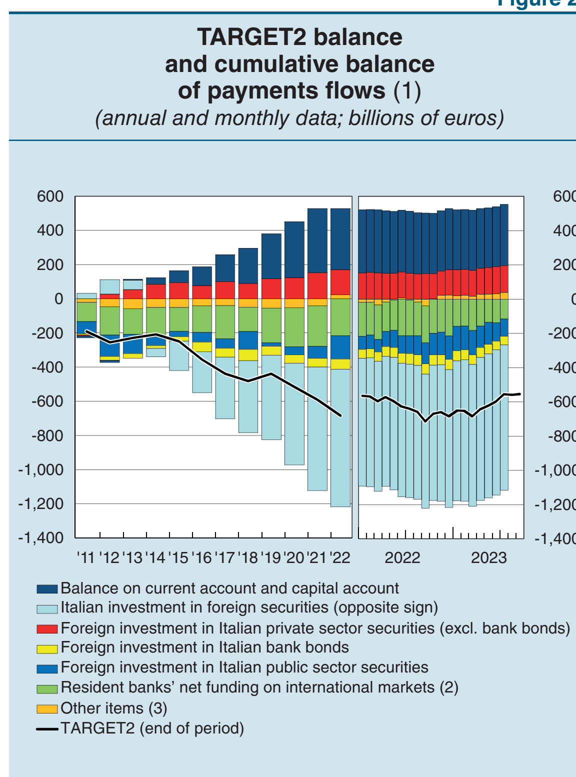
... and the TARGET2 negative balance improves.

The Bank of Italy's negative balance on the TARGET2 European payment system improved significantly in the second quarter (from €685 billion at the end of March to €598 billion at the end of June; Figure 20) in connection with targeted longer-term refinancing operations (TLTRO III) repayments. The decrease of the debt position continued in the summer months, reaching €555 billion at the end of September, thanks to an increase in deposits held by credit institutions with the Bank of Italy.

Figure 20

TARGET2 balance and cumulative balance of payments flows (1)

(annual and monthly data; billions of euros)



(1) Using the balance of payments accounting identity, an increase in the Bank of Italy's negative balance vis-à-vis the ECB in the TARGET2 payment system may reflect investments in Italy by non-residents (greater liabilities), residents' disposals of foreign assets (fewer assets) or a current account and capital account surplus. Cumulative capital flows since July 2011. – (2) Net bank funding in the form of loans, deposits and other investments by the banking sector, including those intermediated by resident central counterparties. – (3) Direct investment, derivatives, residual items in other investment, official reserves, errors and omissions.

The net international investment position remains solid

At the end of June, Italy's net international investment position was positive by €105 billion, equal to 5.3 per cent of GDP. The €21 billion increase compared with end-March was mainly due to valuation adjustments, especially price adjustments, which were positive overall.

2.5 THE LABOUR MARKET

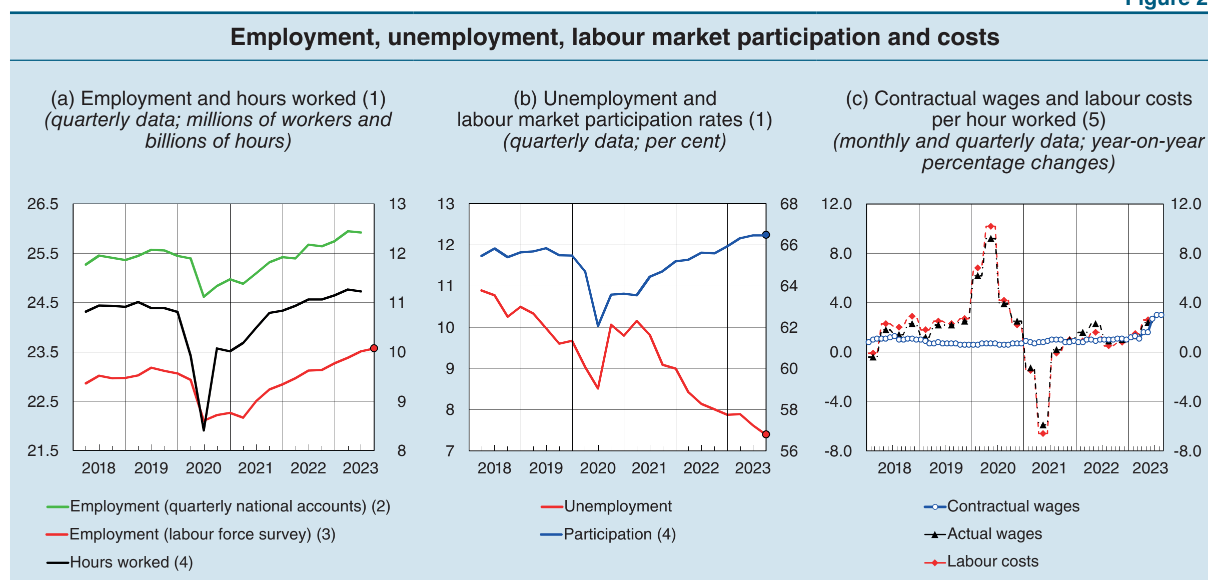
The number of workers continued to rise in the second quarter of 2023, but total hours worked decreased. The participation rate remained high by historical standards and the unemployment rate declined further. However, signs of a slowdown emerged in early summer. Wage growth gathered pace in the non-farm private sector, driven by some contract renewals and by the wage indexation clauses laid down in a limited number of collective agreements.

Employment continues to rise in the spring, but hours worked decrease

According to Istat's labour force survey, the number of persons employed continued to increase in the second quarter (0.6 per cent; Figure 21.a),[5] buoyed by permanent employment and, to a lesser extent, by self-employment. This positive trend is consistent with the change in payroll employment positions observed in mandatory reporting.[6] Growth in employment was stronger in services and relatively smaller in industry excluding construction. The number of employees in construction declined.

Figure 21

Employment, unemployment, labour market participation and costs



Sources: For employment, hours worked, actual wages and labour costs, Istat's CET; for employment and for the labour market participation and unemployment rates, Istat's labour force survey; for contractual earnings, Istat's contractual earnings by type of contract.
(1) Seasonally adjusted data. The points corresponding to Q3 2023 indicate the average value for the two-month period July-August. – (2) Includes all persons engaged in production activity in Italy's economic territory. – (3) Includes all resident persons that are employed, excluding workers living permanently in an institution and military personnel. – (4) Right-hand scale. – (5) Non-farm private sector. Raw monthly data for contractual wages; seasonally adjusted quarterly data for actual wages and labour costs.

According to Istat's quarterly national accounts (*Conti economici trimestrali*, CET), total hours worked fell (-0.4 per cent), resulting in a decline in hours per employee and interrupting the trend that began in the first quarter of 2021.

Employment slows down in July and August

Preliminary data from Istat's labour force survey indicate that employment slowed down in early summer. The number of persons employed remained broadly stable on average in July and August (0.1 per cent more than in the previous two months), mainly due to the contraction in the number of employees on temporary contracts. Mandatory reporting data, which usually anticipate changes observed in other statistical sources, pointed to a slowdown in net hiring already in May and June, both in industry excluding construction and in services, especially in tourism. In the first half of the year as a whole, however, labour demand in tourism grew markedly, owing to the positive trend in visitor flows in the first few months of the year.

[5] Istat's quarterly national accounts (CET) point to broad stability in the number of persons employed in the second quarter (-0.1 per cent), following strong growth in the previous three months (0.8 per cent). However, in the last two years, the quarterly national accounts have shown particularly erratic cyclical variations, both in comparison with the pre-pandemic period and with Istat's labour force survey data. This might be partly due to different seasonal adjustment procedures in the two statistical sources. The divergence between CET and the labour force survey is smaller over a longer horizon: the increase in the number of persons employed in the first half of 2023, compared with the average for the two years 2018-19, was 1.9 and 1.8 percentage points, respectively.

[6] For an analysis of the first six months of the year see Ministry of Labour and Social Policies, Banca d'Italia and ANPAL, 'The labour market: data and analysis', July 2023.

Unemployment shrinks

In the spring, the unemployment rate was 0.3 percentage points lower than in the first three months of the year (Figure 21.b). The activity rate remained high by historical standards, at 66.5 per cent (0.6 percentage points higher than the peak recorded in April-June 2019); however, the difference compared with the euro-area average (75.1 per cent) remains marked. Partly owing to the good performance of labour supply, the contraction in unemployment did not lead to an increase in firms' difficulties in finding workers. The vacancy rate in the non-farm private sector remained stable at 2.3 per cent. According to the latest data, the labour force participation and unemployment rates held broadly stable on average in July and August, compared with the previous two months.

Wage growth gathers pace

In the second quarter, hourly contractual earnings in the non-farm private sector rose by 1.9 per cent on an annual basis, from 1.2 per cent in the first three months of the year (Figure 21.c). This acceleration, which was more marked at the end of the quarter, is mainly due to the wage increases already set out in the bridge agreement in the trade sector – with a raise paid in April – and to the adjustment in June of the wage floors in the metalworking sector (calculated on the basis of the 2022 change in the HICP index excluding imported energy goods). Year-on-year growth remained more pronounced in public services (4.5 per cent), owing to the contract renewals signed last year and the resulting payments made in the first quarter of 2023.

Growth in actual hourly earnings in the non-farm private sector accelerated (2.4 per cent annually, up from 1.3 per cent), driven by contractual adjustments, although still at a lower rate than the euro-area average (see Section 1.2).[7] Unit labour costs in this sector increased more markedly (5.6 per cent) on account of negative average labour productivity growth (-2.8 per cent). This decrease in productivity, which had already started in late 2021, partly reflects a shift in production towards firms whose production processes are more labour-intensive (see the box 'The decline in hourly labour productivity: developments at firm level').

THE DECLINE IN HOURLY LABOUR PRODUCTIVITY: DEVELOPMENTS AT FIRM LEVEL

Following the large fluctuations recorded during the pandemic,[1] between the end of 2021 and the first half of 2023, labour productivity in the Italian non-farm private sector – measured as real value added per hour worked – fell by over 3 percentage points (see panel (a) of the figure). Productivity dropped below pre-pandemic levels in manufacturing and in some service sectors, including information, communication and business services.[2]

Over the last two decades, there has only been one reduction of similar magnitude and persistence, which occurred during the global financial crisis of 2008-09, when both economic activity and labour demand contracted markedly (see panel (b) of the figure). Conversely, the current decrease in productivity is linked to the good performance of employment, which has continued to expand despite the slowdown and subsequent stagnation of value added.

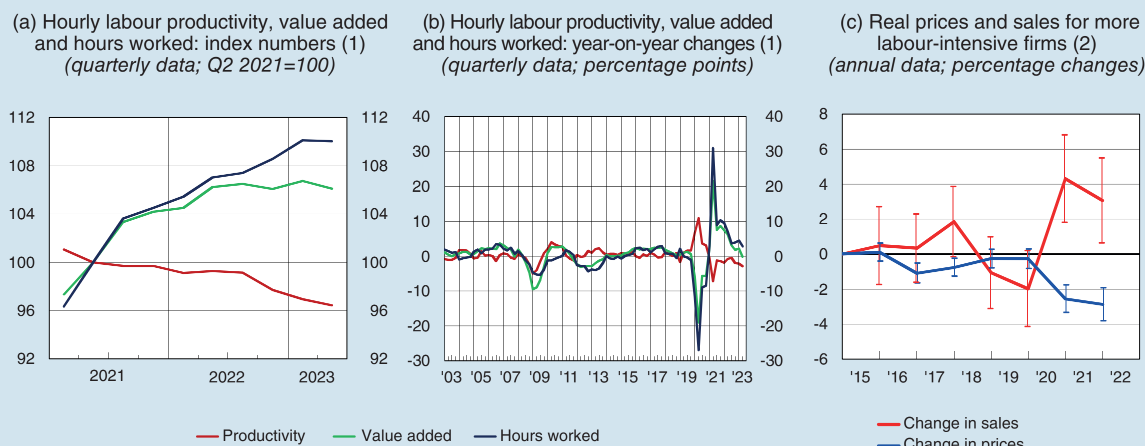
[1] The volatility in productivity observed during the health emergency is largely attributable to significant sectoral recomposition effects and to difficulties in statistical measurement (see Chapter 8 'The labour market', *Annual Report for 2020*, 2021).

[2] The other main euro-area economies, with the exception of Spain, also experienced a decline in average hourly labour productivity. Specifically, between the end of 2021 and spring 2023, value added per hour worked in Germany fell by almost 4 percentage points. In the euro area as a whole, the decrease was greater in services and smaller in manufacturing.

[7] Growth was more modest in public services (1.6 per cent), as substantial one-off amounts and arrears had been paid in the second quarter of 2022 to compensate for the delay in renewing the collective bargaining agreements signed last year but covering the three-year period 2019-21.

Figure

Productivity trends: macroeconomic aggregates and developments at firm level



Sources: Based on Cerved, Invind and Istat's CET.
(1) Non-farm private sector. – (2) The chart shows the difference in annual growth in real prices and sales, all other things being equal, between more labour-intensive and more intermediate-goods-intensive firms. This difference is calculated by regressing the different variables on an indicator that identifies labour-intensive firms. The indicator is 1 if the ratio of labour costs to the cost of intermediate goods incurred by the company in 2019 was higher than the median value in the relevant sector of economic activity; otherwise, the indicator is 0. In order to account for both potential heterogeneities at firm level and overall cyclical developments, this estimate includes firm and annual fixed effects. The vertical bars represent the 95 per cent confidence intervals of the estimates.

Our research, based on data from the Survey of Industrial and Service Firms (Invind),[3] suggests that the decline in value added per hour worked could at least partly be explained by the composition effects resulting from changes in the relative prices of production inputs. Since the end of 2021, these changes have been driven by the sharp rise in the prices of intermediate and energy goods compared with wage growth. In 2021 and 2022, the most labour-intensive firms gained market shares, i.e. firms whose ratio of labour costs to intermediate goods (including energy) costs was above the sample median before the pandemic. If we compare the developments in selling prices between the labour-intensive firms and other firms, there are no significant differences over the period 2015-2020. From 2021 onwards, the most labour-intensive firms instead recorded more moderate price increases, all other things being equal, than the rest of the sample (over 4 percentage points lower in 2021 and 2022), probably due to more favourable cost developments (see panel (c) of the figure). As a result, over the past two years, labour-intensive firms have benefited from better sales performance in real terms. The shift towards these firms (at the expense of more intermediate-goods-intensive firms) leads, for a given level of aggregate demand, to an increase in employment[4] and, consequently, to a reduction in average productivity.

After two years of sharp hikes, the prices of intermediate goods and energy commodities have been falling overall since early 2023, while wages have gradually been growing: the realignment of relative costs could therefore dampen labour demand in the coming months, while sustaining a pick-up in average labour productivity.

[3] The study was based on the Invind survey for the period 2015 to 2022, the latest available data. The survey data have been linked to the Cerved budget database.

[4] Employment growth was also supported by input substitution within firms. Some firms, especially the most intermediate-goods-intensive ones, appear to have partially shifted their production processes towards a more intensive use of labour, which has become relatively cheaper. However, based on our preliminary assessments, this trend is quantitatively less significant.

Following the agreement in the wood sector and the payment of the increases laid down in some contracts still in force in industry, negotiated wages accelerated in July and August (to 3.0 per cent in the non-farm private sector). Possible contract renewals, notably in the private services sector, where the collective bargaining agreements of almost three quarters of employees have expired, may give rise to upward pressures in the final months of this year. However, overall wage growth is expected to remain moderate in light of protracted negotiations, especially in trade and tourism, which could lead to new collective bargaining agreements being pushed back to 2024.

2.6 PRICE DEVELOPMENTS

Consumer price inflation, which had been falling almost continuously since the end of last year, rose slightly in September, driven above all by higher fuel prices. Core inflation remained broadly unchanged, having declined gradually since April, owing to the easing of production pressures and to weaker domestic demand. Firms and households expect price growth to subside over the next few months.

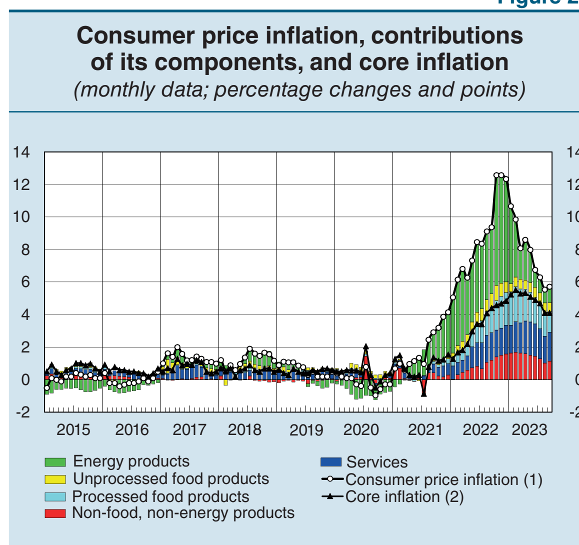
Higher fuel prices push up consumer price inflation

The fall in harmonized consumer price inflation came to a halt in September, rising to 5.7 per cent year-on-year from 5.5 per cent in August (Figure 22 and Table 6). Specifically, this was due to the growth in energy prices, which returned to positive territory owing to the acceleration in fuel prices driven by the rise in oil prices (see Section 1.1) and the recovery in refining and distribution margins. In contrast, the year-on-year decline in electricity and gas prices continued. Inflation in food products declined, but remains high. Core inflation remained practically stable, at 4.1 per cent, 1.4 percentage points lower than the peak reached last February. The greater contribution from air transport service prices, boosted by fuel prices, was actually offset by a further slowdown in goods prices, owing to waning demand and to lower production costs due to the gradual absorption of previous increases in energy prices. Inflation, as measured by the index of consumer prices for the entire resident population (NIC) fell from 5.4 to 5.3 per cent.[8]

Figure 22

Consumer price inflation, contributions of its components, and core inflation

(monthly data; percentage changes and points)



Source: Based on Eurostat data.
(1) 12-month change in the HICP. – (2) 12-month change in the HICP excluding energy and food.

For the last three months of 2023, the Italian Regulatory Authority for Energy, Networks and the Environment (ARERA) announced a quarter-on-quarter increase of around 20 per cent in electricity prices on the regulated market, mainly due to higher wholesale energy market prices (see Section 1.1). These tariffs are still around 50 per cent lower than they were a year ago. For the fourth quarter of 2023, the Government has introduced some new measures to mitigate the impact on vulnerable households of higher energy prices, and has also extended those in force (see Section 2.9).

[8] The different trend compared with inflation measured by the HICP is largely explained by the different treatment of seasonal sales, which is reflected in the dynamics of clothing and footwear prices.

Producer price pressures weaken

In August, the year-on-year decline in the production prices of industrial goods sold on the domestic market intensified further: the contraction in energy prices, which has been considerable since the spring, and that in intermediate goods, which has been more recent and smaller, have been accompanied by a slowdown in the growth rate of other goods. In line with this, in September, the PMI indicator for manufacturing firms continued to point to a reduction in production costs, though less marked than in the previous months. In the second quarter, wage growth rose compared with the previous three months (to 2.7 per cent on an annual basis), driven above all by the non-farm private sector (to 1.9 per cent; see Section 2.5). In this sector, the growth in hourly unit labour costs rose to higher values than those recorded in the first quarter (reaching 5.6 per cent), against a drop in hourly productivity. Profit margins – measured by the ratio of the production deflator to variable unit costs (mark-up) – declined in all sectors, more so in construction, standing below pre-pandemic levels overall. Labour market

Table 6

Indicators of inflation in Italy

(year-on-year percentage changes, unless otherwise specified)

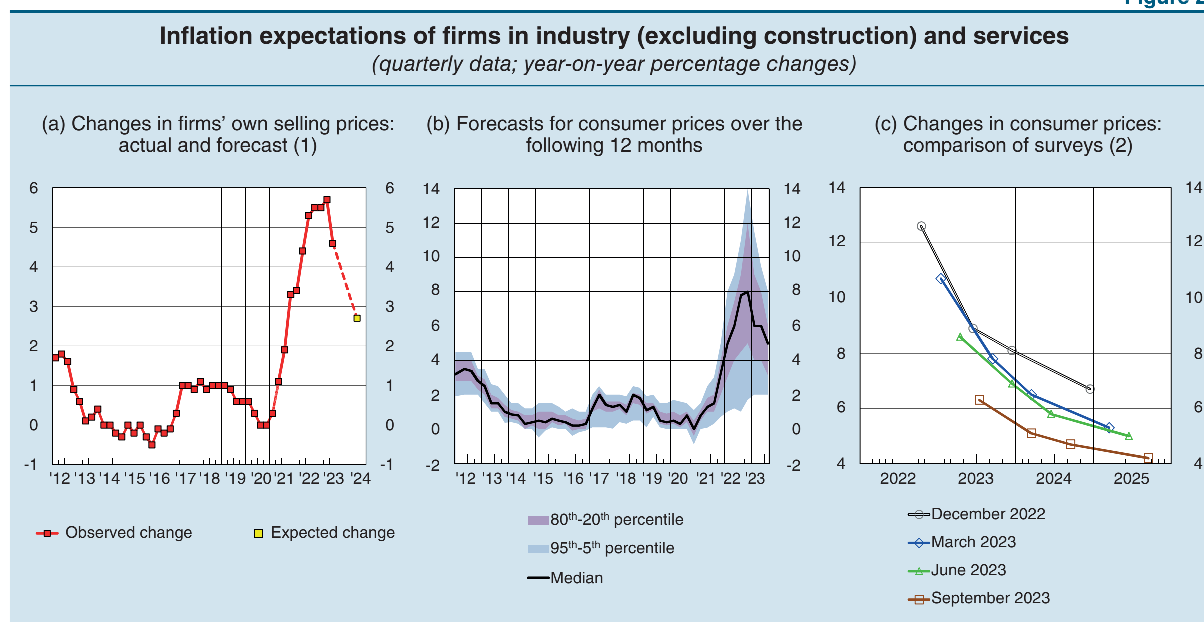
	HICP		CPI (1)	PPI (2)
	General index	Excl. food and energy	General index	General index
2020	-0.1	0.5	-0.2	-4.4
2021	1.9	0.8	1.9	13.0
2022	8.7	3.3	8.1	42.8
2022 – July	8.4	3.4	7.9	45.9
Aug.	9.1	4.1	8.4	50.5
Sept.	9.4	4.4	8.9	52.9
Oct.	12.6	4.6	11.8	33.2
Nov.	12.6	4.7	11.8	35.7
Dec.	12.3	4.8	11.6	39.2
2023 – Jan.	10.7	5.2	10.0	11.6
Feb.	9.8	5.5	9.1	10.0
Mar.	8.1	5.3	7.6	3.0
Apr.	8.6	5.3	8.2	-3.5
May	8.0	5.1	7.6	-6.8
June	6.7	4.9	6.4	-8.2
July	6.3	4.7	5.9	-13.8
Aug.	5.5	4.0	5.4	-16.1
Sept.	(5.7)	(4.1)	(5.3)	...

Sources: Based on Istat and Eurostat data. The figures in brackets are preliminary estimates.
(1) National consumer price index for the entire resident population. This differs from the HICP principally because of the different method for recording the prices of pharmaceutical products and promotional sales. – (2) Index of producer prices of industrial products sold on the domestic market.

Figure 23

Inflation expectations of firms in industry (excluding construction) and services

(quarterly data; year-on-year percentage changes)



Source: Based on the findings of the Bank of Italy's quarterly 'Survey on Inflation and Growth Expectations'. Up to October 2018, the survey was conducted jointly with Il Sole 24 Ore.
(1) Average (excluding outliers) of firms' responses to questions on the percentage change in their own prices over the previous 12 months and the change expected over the following 12 months. – (2) The key below the chart indicates the month in which the survey was carried out. The first point on each curve is the latest definitive figure for inflation available at the time of the survey (usually referring to two months earlier); the figure is provided in the questionnaire to be used as the basis on which firms can formulate their expectations; the second point is the average of the respondents' forecasts for inflation 6 months following the survey date; the third point is the average 12 months forward; and the fourth point is the average 24 months forward.

information for the third quarter suggests that the upward pressures from contract renewals remain limited overall (see Section 2.5).

Households and firms continue to expect inflation to fall

Istat's surveys show that, in September, the share of households that expect a weakening of inflationary pressures continued to prevail. Those over a three-year horizon, taken from the ECB's Consumer Expectations Survey in August, remained broadly stable, at a median value of around 3.2 per cent. The expectations for consumer price inflation of firms surveyed as part of the *Survey on Inflation and Growth Expectations* declined further, although they remain close to 4.5 per cent for the next 12 months, and below 4 per cent over the horizon three to five years forward. In the 12 months following the survey, firms also expect slower growth in their own list prices, more marked in industry excluding construction and in services (2.7 per cent on average; Figure 23) than in construction (4.9 per cent).

2.7 BANKS

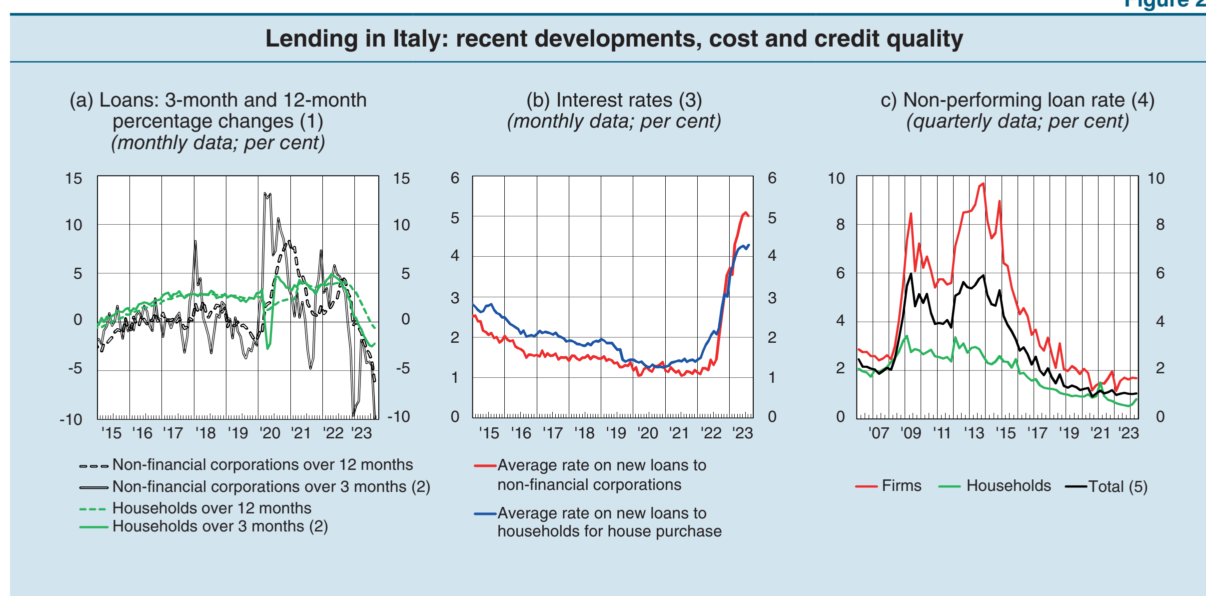
Between May and August, the fall in bank loans to firms and households became more pronounced. The decline reflected both the marked weakness in credit demand, which was held back by the rise in the cost of loans and the lower liquidity needed to finance investment, and the tightening of credit standards, mainly driven by banks' higher risk perception and lower risk tolerance. The increase in the ECB's key interest rates continues to be transmitted to the cost of credit. The decline in sight deposits continued, partially offset by increases in other kinds of deposits. The non-performing loan rate remained low in the second quarter of 2023.

Lending to firms and households continues to shrink ...

In August, lending to the non-financial private sector dropped at a sharper pace (Figure 24.a). The contraction in loans to non-financial corporations became more pronounced (-9.9 per cent on a quarterly annualized basis, from -4.2 per

Figure 24

Lending in Italy: recent developments, cost and credit quality



Sources: Central Credit Register and supervisory reports.
(1) Includes bad debts, repos and loans not reported in banks' balance sheets because they have been securitized. The percentage changes are net of reclassifications, exchange rate variations, value adjustments, and other variations not due to transactions. 3-month percentage changes are annualized. – (2) Data are seasonally adjusted following a methodology that is in accordance with the guidelines of the European Statistical System. – (3) Average values. Rates on loans refer to euro-denominated transactions and are collected and processed in accordance with the Eurosystem's harmonized methodology. – (4) Annualized quarterly flows of non-performing loans adjusted to the stock of loans, net of adjusted non-performing loans, at the end of the previous quarter. Seasonally adjusted where applicable. – (5) The total includes households, firms, financial corporations, the foreign sector, general government, and non-profit institutions.

cent in May) and lending to households decreased further (-2.2 per cent, from -1.9 per cent). The fall in financing reflects the tighter credit standards and weaker demand for loans.

In year-on-year terms, the contraction in loans to firms continued to be stronger for firms with less than 20 employees (-9.2 per cent). It became sharper in both manufacturing and services (-6.4 and -6.1 per cent, respectively, from -3.8 and -2.4 per cent in May).

... reflecting tighter credit standards and weak demand

The Italian banks interviewed in July for the euro-area bank lending survey (BLS)[9] reported that they had further tightened credit standards for firms in the second quarter of 2023, though less so than in the three earlier quarters. According to the banks interviewed, firms' demand for loans fell further, owing to reduced financing needs for investment and the general increase in interest rates. Credit standards for households were unchanged following the gradual tightening observed since the second quarter of last year. Demand appears to have decreased for both mortgage loans for house purchase and consumer credit loans. Banks reported that they expected to tighten their lending policies for firms, while keeping those for households unchanged. Since the beginning of the ECB's monetary policy normalization process, the credit standards for households and firms have become more stringent in both Italy and the euro area. This was in response to banks' higher risk perception and lower risk tolerance and – to a lesser extent – to a worsening of bank funding conditions (see the box 'Credit supply and demand since the start of monetary policy normalization').

CREDIT SUPPLY AND DEMAND SINCE THE START OF MONETARY POLICY NORMALIZATION

Since the start of the monetary policy normalization process undertaken by the ECB at the end of 2021, bank credit supply policies have become stricter over time and demand from firms and households has weakened markedly in both Italy and the euro area. The possible repercussions of the sudden increase in the ECB's key interest rates on the financial soundness of borrowers have probably contributed, together with the effects of the energy crisis, to an increase in banks' risk perceptions; this increase has contributed more markedly to the tightening of credit standards than the tightening cycle that started in 2005. At the same time, the uncertainty about the economic outlook has dampened business and consumer confidence, contributing to a fall in credit demand.

According to the bank lending survey (BLS), banks in Italy have gradually tightened their credit standards and the terms and conditions applied to loans granted in 2022 and the first quarter of 2023, both for loans to firms (see panel (a) of the figure) and for loans to households for house purchase (see panel (b) of the figure). As regards consumer credit and other lending, the tightening of credit standards has been minor since the start of monetary normalization, while terms and conditions have undergone a more marked tightening. The tightening of credit standards mainly reflected banks' higher risk perceptions and lower risk tolerance, while the cost of funding and balance sheet constraints have had a moderate impact.[1] The tightening of the terms and conditions applied to loans to firms and households for house purchase has affected the margins applied, the loan size, maturities and the collateral requirements. According to banks, the measures aimed at gradually reducing the

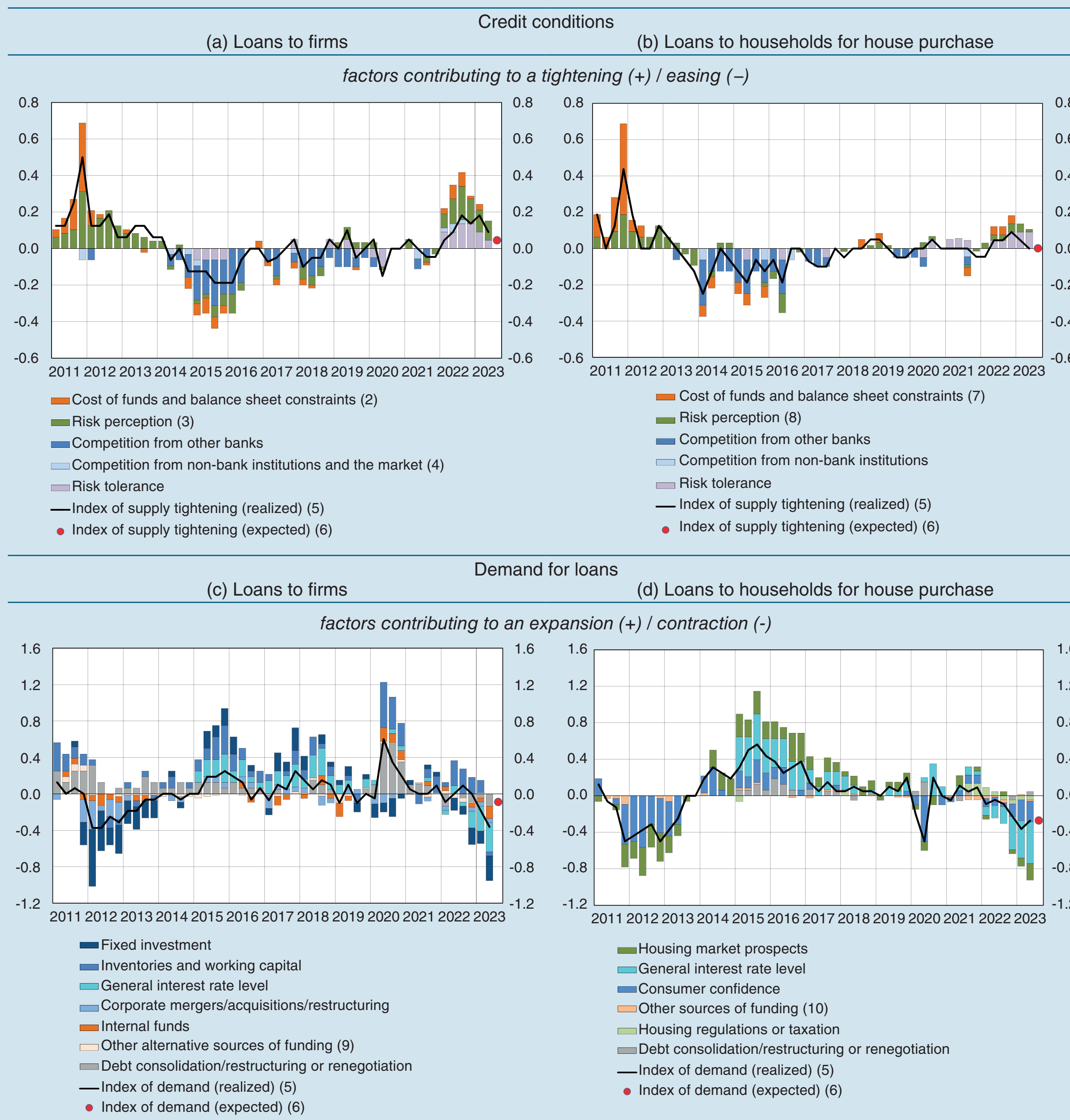
[1] Banks' responses to the specific question on the conditions for access to funding indicate that they worsened during the process of monetary policy normalization, particularly in the second and third quarters of 2022, before returning to overall stability in the second quarter of this year.

[9] Thirteen of the leading Italian banking groups took part in the survey. The results for Italy are available on the Bank of Italy's website: 'Bank Lending Survey (BLS)'. For those relating to the euro area, see the ECB's website, 'July 2023 euro area bank lending survey', press release, 25 July 2023.

Figure

Credit standards and the trend in credit demand in Italy (1)

(quarterly data; diffusion indices)



Source: BLS.

(1) For the general indices, positive values indicate supply tightening/demand expanding compared with the previous quarter; for the factors, positive values indicate a contribution to supply tightening/demand expanding compared with the previous quarter. The diffusion indices are constructed on the basis of the following weighting scheme: for supply conditions, 1=tightened considerably, 0.5=tightened moderately, 0=basically stable, -0.5=eased moderately, -1=eased considerably; for demand, 1=increased considerably, 0.5=increased moderately, 0=basically stable, -0.5=decreased moderately, -1=decreased considerably. The range of variation of the index is from -1 to 1. – (2) Average of the following factors: bank's capital position; bank's ability to obtain funds on the market; bank's liquidity position. – (3) Average of the following factors: general economic situation and outlook; industry- or firm-specific situation and outlook; risks associated with collateral. – (4) Average of the following factors: competition from non-banks and competition from other sources of finance. – (5) For the quarter ending at the time of the survey. – (6) Forecasts prepared in the previous quarter. – (7) From April 2022, average of the following factors: bank's capital position; bank's ability to obtain funds on the market; bank's liquidity position. – (8) Average of the following factors: general economic situation and outlook; housing market prospects; borrower's creditworthiness. – (9) Average of the following factors: loans granted by other banks; loans from non-banks; issuance/redemptions of debt securities; issuance/redemptions of equity. – (10) Average of the following factors: self-financing of house purchase with savings; loans from other banks; other sources of external funding.

size of the Eurosystem's balance sheet have also contributed to the worsening of credit terms and conditions since summer 2022.

In the latest survey round, covering the second quarter of 2023, banks reported a further, albeit more moderate, tightening of credit standards applied to loans to firms, while those for loans to households remained stable.

Since the last quarter of 2022, the increase in the general level of interest rates and the lower financing needs for investment spending have contributed markedly to the weakening of firms' loan demand in Italy; until then, however, demand had remained high in part thanks to high inventory and working capital needs (see panel (c) of the figure). Households' demand for loans for house purchase has also declined since the start of normalization, reflecting the general increase in interest rates and waning consumer confidence (see panel (d) of the figure). The demand for consumer credit began to decrease in the third quarter of 2022. In the latest survey round, covering the second quarter of 2023, banks reported a further drop in the demand for loans from firms and households.

Similar trends were observed in both credit supply and credit demand in the euro area. At the beginning of 2022, a gradual worsening, which is ongoing, began in credit standards and in the terms and conditions of loans to firms and to households for house purchase. Demand for loans from both sectors declined considerably.

The increases in the ECB's key interest rates are still being transmitted to the cost of credit for firms and households

Compared with May, the average interest rate on new loans to firms increased by 0.2 percentage points, to 5.0 per cent in August (Figure 24.b). The interest rate on new loans to households for house purchase rose by 0.1 percentage points, to 4.3 per cent. It went up by 0.4 percentage points for variable rate mortgages while it was practically unchanged for loans with a fixed rate for at least one year. Since the beginning of the monetary policy normalization process, the rate on new loans has risen by 3.8 percentage points for firms and by 2.9 percentage points for mortgage loans.[10]

Bank funding continues to decline

In August, bank funding fell by 7.9 per cent on an annual basis. The decline was attributable to the trends in deposits by residents (-5.4 per cent; Table 7) and to the decrease in liabilities to the Eurosystem as a result of repayments of TLTRO III funding. Since the start of the monetary policy normalization process, growth in residents' deposits has gradually weakened, reflecting developments in current account deposits (-10.6 per cent in August). The rate of growth of sight deposits, which was 9.7 per cent at the end of 2021, slowed gradually and entered negative territory in November 2022. The contraction subsequently continued at a faster pace and was only partially offset by stronger growth in other deposits (13.2 per cent). This shift is due to the slower adjustment of the interest rates on current account deposits to changes in the key interest rates compared with fixed-term deposits. This also appears to have supported an increase in households' demand for government bonds. The marginal cost of funding stood at 2.0 per cent (from 1.8 per cent in May);[11] it was virtually nil at the start of the monetary policy normalization phase.

[10] The pass-through of monetary tightening to the cost of credit has so far been broadly in line with that observed in the tightening cycle that started at the end of 2005 (see the box 'The transmission of monetary tightening to the cost of credit', Chapter 3, *Annual Report for 2022*, 2023).

[11] This is the cost that a given bank would incur to increase its balance sheet by one unit, drawing on funding sources in proportion to the composition of its liabilities at that time.

Table 7

Main assets and liabilities of Italian banks (1)
(billions of euros and percentage changes)

	End-of-month stocks		12-month percentage changes (2)	
	May 2023	August 2023	May 2023	August 2023
Assets				
Loans to Italian residents (3)	1,701	1,675	-1.8	-4.2
of which: firms (4)	637	625	-2.8	-6.2
households (5)	676	673	0.8	-0.6
Claims on central counterparties (6)	39	30	6.6	-9.3
Debt securities (7)	526	516	-4.4	-4.5
of which: securities of Italian general government entities (8)	383	374	-5.3	-6.7
Claims on the Eurosystem (9)	300	207	-25.4	-38.4
External assets (10)	523	515	5.5	4.2
Other assets (11)	863	847	7.1	1.0
Total assets	**3,952**	**3,790**	**-1.7**	**-5.0**
Liabilities				
Deposits of Italian residents (3) (12) (13)	1,806	1,780	-4.3	-5.4
Deposits of non-residents (10)	375	402	16.9	25.5
Liabilities towards central counterparties (6)	126	110	4.1	3.2
Bonds (13)	223	233	13.2	18.3
Liabilities towards the Eurosystem (9)	319	179	-29.7	-58.5
Liabilities connected with transfers of claims	118	121	-2.4	4.3
Capital and reserves	346	352	2.4	4.7
Other liabilities (14)	639	614	8.6	1.7
Total liabilities	**3,952**	**3,790**	**-1.7**	**-5.0**
of which: total funding (15)	2,810	2,674	-4.5	-7.9

Source: Supervisory reports.
(1) August 2023 data are provisional. – (2) Adjusted for reclassifications, value adjustments and exchange rate movements. Changes in loans to firms and households are adjusted for securitizations. – (3) Excludes transactions with central counterparties. – (4) Harmonized definition, excludes producer households. – (5) Harmonized definition, includes producer households, non-profit institutions serving households and households not classified elsewhere. – (6) Only repos. – (7) Excludes bonds of resident MFIs, i.e. banks and money market funds. – (8) Includes only securities of Italian general government entities. – (9) Includes the accounts with the Eurosystem for monetary policy operations; see Tables 3.3a and 3.3b in 'Banks and Money: National Data', Banca d'Italia, Statistics Series. – (10) In the period considered these refer mainly to interbank transactions. – (11) Includes bonds issued by resident MFIs; loans to resident MFIs; shares and other equity of resident companies; cash; money market fund units; derivatives; movable and immovable property; other minor items. – (12) Excludes liabilities connected with transfers of claims. – (13) Excludes liabilities towards resident MFIs. – (14) Includes bonds held by resident MFIs and deposits of resident MFIs that are considered for the calculation of the marginal cost of funding. Also includes derivatives and other minor items. – (15) Bank funding is the sum of the following items: deposits by residents, deposits by non-residents, liabilities with central counterparties (excluding reverse repos), bonds and liabilities with the Eurosystem.

New non-performing loans remain at low levels

In the second quarter, the ratio of new non-performing loans to total loans held stable at around 1.0 per cent (on a seasonally adjusted and annualized basis; Figure 24.c). The indicator remained broadly unchanged for loans to firms, at 1.7 per cent, while it increased by 20 basis points for loans to households, to 0.8 per cent.

The ratio of non-performing loans to total loans for both the significant banking groups (Table 8) and the less significant ones held stable in the second quarter of 2023, both gross and net of write-downs. The coverage ratio was practically unchanged for both categories of banks.

The profitability of banks increases

In the first half of 2023, profitability grew year-on-year for both significant and less significant banks (though at a slower pace for the latter). Net of

non-recurring items, the improvement in the annualized return on equity (ROE) reflected net interest income growth,[12] which more than offset the decline in other revenues. Operating expenses increased slightly for the significant banking groups, while loan loss provisions decreased considerably.[13] For less significant banks, the rise in costs was more marked and loan loss provisions were practically unchanged. Going forward, the growth in net interest income will likely wane owing to the gradual rise in the interest rates on deposits, which have until now responded less markedly to monetary policy impulses compared with the interest rates on loans. Competition between intermediaries also appears to be offsetting the restrictive impact of other factors (risk and funding conditions) on the terms and conditions applied to new loans. With Law 136/2023, approved on 9 October, the Government introduced a windfall tax on banks (see Section 2.9).

In the second quarter of this year, the capital ratios of significant and less significant banks increased: the former fully recovered the drop observed in the winter months.

Table 8

Main indicators for significant Italian banks (1)
(per cent)

	March 2023	June 2023
Non-performing loans (NPLs) (2)		
Gross NPL ratio	2.4	2.4
Net NPL ratio	1.1	1.1
Coverage ratio (3)	54.4	54.1
Regulatory capital		
Common equity tier 1 (CET1) ratio	15.4	15.9
	H1 2022	H1 2023
Profitability		
Return on equity (ROE) (4)	9.2	14.0
Net interest income (5)	8.5	51.6
Gross income (5)	1.8	20.7
Operating expenses (5)	-3.1	2.6
Operating profit (5)	10.6	49.5
Loan loss provisions (5)	2.2	-44.7

Source: Consolidated supervisory reports.
(1) Provisional data for June and for H1 2023. Significant banks are those directly supervised by the ECB. In 2022 significant groups expanded by two units following the inclusion of Mediolanum and Fineco. The data prior to that date were pro forma recalculated as if the two banks were already significant in the previous periods. – (2) End-of-month data. Includes loans to customers, credit institutions and central banks. The NPL ratio is reported gross and net of loan loss provisions. – (3) The coverage ratio is measured as the ratio of loan loss provisions to the corresponding gross exposure. – (4) Net of non-recurring items. – (5) Percentage changes with respect to the year-earlier period.

2.8 THE FINANCIAL MARKET

Financial market conditions in Italy have worsened again since August, reflecting weaker economic activity and the prospect that the key interest rates will remain at high levels for an extended period of time. The spread between Italian and German ten-year government bond yields has widened.

Yields on long-term government bonds rise

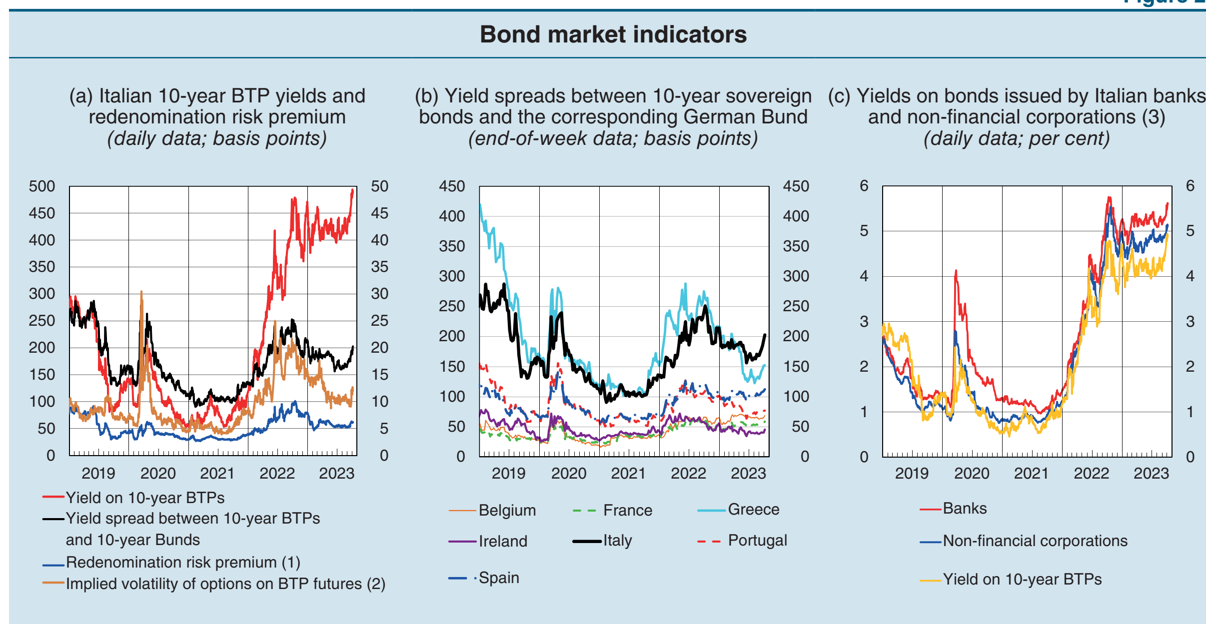
The yield on Italian ten-year government bonds has increased significantly compared with the first ten days of July, driven by higher key interest rates and expectations of a cyclical downturn. It stood at 4.9 per cent at the end of the first week of October, more than 50 basis points higher than at the beginning of the period (Figure 25.a). The volatility implied by derivatives on Italian ten-year government bonds, though on the rise, has remained below first-quarter levels. Liquidity conditions in the market for government bonds are still more favourable than in 2022. The worsening growth outlook and the resulting impact on public finances have pushed the spread between Italian and German ten-year government bond yields higher since the end of August. Investors' slightly higher perception of redenomination risk has also played a part. Over the period as a whole, the yield spread widened by 31 basis points, to 203 basis points at the start of October, the highest level since last December (Figure 25.b).

[12] The pronounced increase in net interest income compared with the first half of last year was ascribable to the fact that the rise in interest rates contributed positively to profitability only starting from the second half of the year.

[13] The sharp decrease compared with the corresponding period of last year is partly due to the sizeable write-downs on exposures to Russia and Ukraine carried out by the two leading groups in the first quarter of 2022.

Figure 25

Bond market indicators



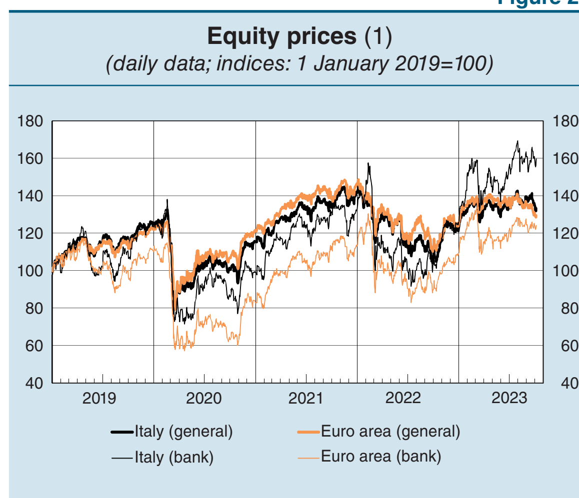
Sources: Based on data from Bloomberg, ICE Bank of America Merrill Lynch, ICE Data Derivatives UK Ltd and Refinitv.
(1) Spread between the premiums on Italian sovereign CDS ISDA-2014 and ISDA-2003 contracts with 5-year maturities. Compared with ISDA-2003, ISDA-2014 contracts offer greater protection against a redenomination of the underlying debt. – (2) Implied volatility of at-the-money options with a 1-month maturity on 10-year BTP futures traded on the Eurex. Right-hand scale. – (3) The data refer to the average yields (to maturity) of a basket of euro-denominated bonds issued by Italian banks and non-financial corporations and traded on the secondary market. Even if the basket contains bonds with different maturities, selected on the basis of an adequate level of liquidity, the figure shows, for comparison purposes, the 10-year BTP yields, which are especially representative of the yields offered on Italian government bonds.

Bond funding costs rise in the private sector

The yields on bonds issued by Italian and euro-area non-financial corporations went up, starting from the first ten days of July (by 11 and 12 basis points, respectively; Figure 25.c). Likewise, bank bond yields rose (by 20 basis points in Italy and 9 basis points in the euro area), with their levels remaining higher than before the US regional bank collapses and the Credit Suisse crisis in March. In the second quarter, net issuance of both non-financial and bank bonds intensified significantly in Italy (€6.4 billion and €6.8 billion, respectively), whereas in the third quarter, based on preliminary data from Bloomberg, redemptions exceeded gross issuance in both sectors, with net redemptions in the banking sector more than offsetting the large number of new issues in the previous quarter.

Figure 26

Equity prices (1)
(daily data; indices: 1 January 2019=100)



Source: Based on Refinitiv data.
(1) Datastream general and bank indices.

Share prices fall

Overall, equity prices in Italy and the euro area fell after the first ten days of July (by 1.2 and 4.3 per cent respectively; Figure 26), reflecting weaker economic activity, the outlook for international trade and high key interest rate levels for longer than expected. Overall, bank stock valuations rose by 3.7 per cent in Italy and by 3.3 per cent in the euro area, buoyed by market expectations of higher profitability, partly as a result of the ECB's decision to raise key interest rates. At the beginning of August, following the Italian Government's announcement of a

windfall tax on lenders, Italian bank stocks lost ground, though only temporarily, partly due to changes diluting the impact of this measure (see Section 2.9).

2.9 THE PUBLIC FINANCES

The Italian Government has updated its public account estimates and targets for 2023 and for the next three years. According to the new targets, in 2023, net borrowing and debt are now projected to stand at 5.3 and 140.2 per cent of GDP, respectively. The 2023 deficit – about 0.8 percentage points of GDP higher than last spring's target – reflects, among other things, the strong growth in a number of tax credits for building renovation projects accruing in the current year ('Superbonus'). The government plans to allow the deficit to widen compared with the current legislation scenario by about 0.7 percentage points of GDP in 2024. However, net borrowing is expected to continue to decline gradually over the next few years, to 2.9 per cent of GDP in 2026. The debt-to-GDP ratio is set to decrease only marginally over the three years 2024-26. The third instalment of funds available under the Recovery and Resilience Facility (RRF) was disbursed on 9 October.

Net borrowing and debt to GDP are set to decline further in 2023

On 27 September, the Government approved the Update to the 2023 Economic and Financial Document (NADEF).[14] Based on current legislation, net borrowing for this year is estimated to decline from 8.0 per cent of GDP in 2022 to 5.2 per cent (Table 9). This figure is, however, approximately 0.7 percentage points higher than the April target, largely due to higher spending on building renovation incentives ('Superbonus').[15] Compared with the current-legislation scenario, the Government expects net borrowing to grow by over 0.1 percentage points of GDP in connection with (a) the decision to bring forward the adjustment of pension payments for inflation, which otherwise would have taken place in 2024,

Table 9

Public finance targets and estimates for 2023
(per cent of GDP)

	General government				*Memorandum items:*	
	Net borrowing	Structural net borrowing	Primary surplus	Change in debt (1)	Real GDP growth rate	Nominal GDP growth rate
Targets						
November 2022 (2)	4.5	4.8	-0.4	-1.1	0.6	4.8
April 2023 (3)	4.5	4.9	-0.8	-2.3	1.0	5.8
September 2023 (4)	5.3	5.9	-1.5	-1.5	0.8	5.3
Estimates based on current legislation						
September 2022 (5)	3.4	3.6	0.5	-2.2	0.6	4.4
November 2022 (2)	3.4	3.6	0.7	-1.9	0.3	4.6
April 2023 (3)	4.4	4.9	-0.6	-2.4	0.9	5.7
September 2023 (4)	5.2	5.7	-1.4	-1.7	0.8	5.3

(1) Year-on-year change in the debt-to-GDP ratio. – (2) Update to the 2022 Economic and Financial Document. Revised extended version. – (3) 2023 Economic and Financial Document. – (4) Update to the 2023 Economic and Financial Document. – (5) Update to the 2022 Economic and Financial Document.

[14] 'Preliminary hearing on the Update to the 2023 Economic and Financial Document' (only in Italian), testimony by S. Nicoletti Altimari, Director General for Economics, Statistics and Research at the Bank of Italy, before the 5th Committee of the Senate of the Republic (Economic Planning and Budget) and the 5th Committee of the Chamber of Deputies (Budget, Treasury and Planning), sitting jointly, Senate of the Republic, Rome, 9 October 2023.

[15] In its opinion of 26 September 2023, Eurostat, the EU statistical office, stated that 'Superbonus' tax credits accruing in 2023 should be fully accounted for on an accrual basis as net borrowing for the current year, using the same statistical approach as for 2020-22 incentives (see *Economic Bulletin*, 2, 2023). No final decisions have been taken on the classification of credits maturing in 2024, which will require further analysis. Eurostat also specified that accounting for Superbonus tax credits as 'payables' – i.e. on an accrual rather than a cash basis – rests on the assumption that there is a tiny probability of taxpayers using only part of these credits. By mid-2024, Eurostat could therefore reconsider its decisions on the classification of this tax incentive as of 2020, if the above assumption were not confirmed by actual data on the use of accrued credits.

Table 10

Outturns and official targets for key public finance indicators (1)
(per cent of GDP)

	2022	2023	2024	2025	2026
Net borrowing	8.0	5.3	4.3	3.6	2.9
Primary surplus	-3.8	-1.5	-0.2	0.7	1.6
Interest expense	4.3	3.8	4.2	4.3	4.6
Structural net borrowing	8.7	5.9	4.8	4.3	3.5
Debt (2)	141.7	140.2	140.1	139.9	139.6

Source: Update to the 2023 Economic and Financial Document.
(1) Outturns for 2022 and official targets for 2023-26. Any mismatches are due to the rounding of decimals. – (2) Gross of financial support to other EMU countries.

(b) the introduction of new measures in the area of public sector employment, and (c) new provisions addressing migration. The debt-to-GDP ratio is expected to fall from 141.7 per cent in 2022[16] to 140 per cent based on current legislation and to 140.2 per cent in the policy scenario (Table 10).

The borrowing requirement worsens, partly due to the use of tax credits that accrued in the past

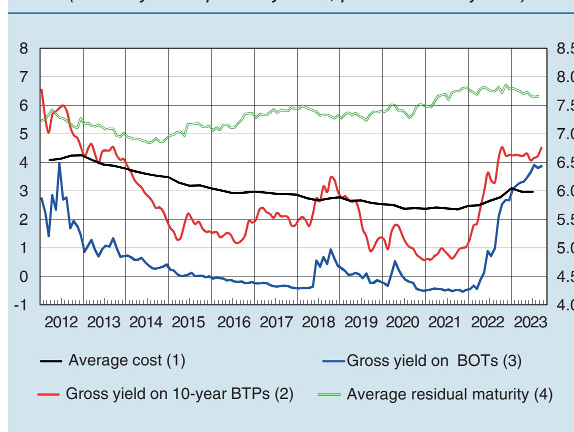
In the first nine months of 2023, the state sector borrowing requirement was around €102 billion, up by over €51 billion compared with the corresponding period of 2022. For general government as a whole, for which data are only available for the first eight months of the year, the borrowing requirement came to approximately €66 billion, almost €44 billion higher than in the corresponding period of 2022. These trends are still in line with a significant reduction in net borrowing in 2023 compared with the previous year. The use of part of the tax credits that accrued in 2020-22 under building renovation incentives ('Superbonus' and 'Bonus facciate'), which had already been accounted for in net borrowing in those years, may have contributed significantly to cash balance trends. On the contrary, the borrowing requirement for 2023 is not influenced by newly accrued credits, which can only be used by taxpayers in the future.

The tax revenue entered in the State's budget, net of lottery and gaming receipts, increased by around 7 per cent (€25 billion) in the first nine months of 2023 compared with the same period of last year, mainly due to higher direct tax revenue.

In August, general government debt was €2,840.7 billion, more than €83 billion higher than at end-2022, largely reflecting the borrowing requirement, the Treasury's higher cash holdings and the revaluation of inflation-linked securities. The average residual maturity of debt shortened somewhat, to 7.7 years in August, down slightly from 7.8 years at the end

Figure 27

Gross yields on BOTs and 10-year BTPs, average cost and average residual maturity of debt
(monthly and quarterly data; per cent and years)



Source: Istat, for interest expense.
(1) Ratio of interest expense in the four quarters ending in the reference quarter to the stock of debt at the end of the corresponding year-earlier quarter. – (2) Average monthly yield to maturity of the benchmark traded on the online government securities market. – (3) The yield at issue is the average, weighted by the issue amounts allotted, of the compound allotment rates at the auctions settled during the month. – (4) Right-hand scale.

[16] Istat's revision of nominal GDP for the two years 2021-22 at end-September 2023 resulted in an outright reduction in the debt-to-GDP ratio of almost 3 percentage points compared with previous data. For more details, see Istat, 2023, op. cit.

of 2022.[17] In spite of yields at issue rising in recent months, the average cost of debt inched down from 3.1 per cent in December 2022 to 3 per cent at the end of June 2023, owing to a lower revaluation of inflation-linked securities (Figure 27). Following the end of the reinvestments by the Eurosystem under the asset purchase programme (see Section 1.2), the share of public debt held by the Bank of Italy fell to 25.1 per cent in August, from a peak of 26.2 per cent in October last year.

The Government plans to resort to budget variance in 2024

In the 2023 NADEF estimates based on current legislation, net borrowing will continue to decline over the next three years, to 3.6 per cent of GDP in 2024, 3.4 per cent in 2025 and 3.1 per cent in 2026, at the end of the projection horizon. This trend is less favourable than in the April projections, partly due to a cyclical downturn and higher interest expense. Against this current-legislation scenario, the Government has set a net borrowing target of 4.3 per cent of GDP for 2024 (0.7 percentage points higher than in the current-legislation scenario). Over the following two years, the next budget law is expected to have virtually zero impact on the budget balance, which is set to worsen slightly in 2025, before improving modestly in 2026. Therefore, in the policy scenario, net borrowing is projected to stand at 3.6 per cent of GDP in 2025 and 2.9 per cent in 2026. The Government plans to use this budget variance to achieve the following: (a) extend the cut in the tax wedge into 2024; (b) launch a tax reform; (c) take a number of family welfare measures; (d) renew collective bargaining agreements for some categories of public sector employees; and (e) take measures to encourage investment in the South and Islands.

The debt-to-GDP ratio is set to decline only marginally over the next three years

In the policy scenario, the debt-to-GDP ratio is projected to decrease only marginally over the next three years, with a target of 139.6 per cent at the end of the NADEF horizon. In the Government's plans, over the coming years, the favourable effects of a positive differential between growth and the average cost of debt, as well as of the primary balance edging back into surplus, should only offset the negative impact of a large stock-flow component. The latter is driven upwards by the use of building renovation tax credits and downwards by the planned reduction in the Treasury's cash holdings and by privatization receipts (by at least one percentage point of GDP over the three-year period). As shown by analysis included in the NADEF, the downward trend in the debt-to-GDP ratio remains subject to short- and medium-to-long-term risks that cannot be overlooked. They should be countered through fiscal policy as well as through reforms that can increase Italy's growth potential.

Government provisions include an extraordinary tax on banks …

Decree Law 104/2023, passed in early August, introduced, among other things, an extraordinary tax on banks for 2023, whose structure has been significantly changed as part of the parliamentary review process to convert the provision into law.[18] In the final version of the piece of legislation (Law 136/2023), the tax base is determined with reference to the change in interest margin, with a 40 per cent tax rate. However, the levy cannot exceed 0.26 per cent of the value of risk-weighted assets in the financial year prior to the one in progress on 1 January 2023. For almost all banks, the tax amount should be determined by the risk-weighted asset limit. The provision also allows individual banks to allocate an amount equal to two and a half times the tax due to a non-distributable reserve, in lieu of payment. The revenue will depend on individual banks' decisions to pay the tax or create reserves.

[17] This Economic Bulletin reports the debt and the general government borrowing requirement data that were revised in connection with the notification transmitted to the European Commission on 29 September 2023, as part of the excessive deficit procedure. There were minor revisions to the data published on 15 September, which reflect regular source updates. For more details, see 'The Public Finances: Borrowing Requirement and Debt', Banca d'Italia, Statistics Series, 16 October 2023.

[18] At the request of Italy's Ministry of Economy and Finance, in September, the ECB's Governing Council issued an opinion on the original version of this tax, pointing to some critical aspects in its design and to the risks that could stem from its application (particularly, greater difficulty for banks in accumulating reserves and a deterioration in investor confidence, given the retroactive nature of the provision, with a potential negative impact on the supply of credit). See ECB, 'Opinion of the European Central Bank of 12 September 2023 on the imposition of an extraordinary tax on credit institutions', 12 September 2023.

… a plan to invest in telecommunications networks and support measures in the area of energy

The Government has also taken a number of decisions on equity investments in companies of strategic national importance, namely to participate – with a minority share – in the acquisition of TIM's fixed telecommunications network. For this purpose, Decree Law 118/2023 of 31 August 2023 unlocked up to €2.5 billion in financial resources for the current year. [19]

Decree Law 131/2023, passed in late September, also provided for a number of measures in the last quarter of 2023 to mitigate the effects of higher energy prices. The measures include a VAT reduction on natural gas, zero system charges in the gas sector, cuts to electricity and gas bills for lower-income households, and a number of one-off allowances covering purchases of fuel or, as an alternative, public transit passes. Overall, these measures are expected to have no impact on net borrowing as their costs should be mostly covered by cost savings on previous measures.

Progress is made on the NRRP, with the disbursement of the third tranche

In early August, the Government applied for a comprehensive review of the National Recovery and Resilience Plan (NRRP). The proposed amendments cover 144 projects, including nine (worth around €16 billion) that the Government intends to remove from the NRRP and complete using national funds. The remaining changes mostly consist of lower quantitative targets and extended deadlines. The updated version of the NRRP also contains a new chapter under the REPowerEU programme. These measures, worth around €19 billion, should be financed through new EU grants and 2021-27 cohesion funds, as well as using any resources freed up by project removals.[20] After the EU Council approved Italy's July proposal to amend a number of milestones and targets required for disbursing the fourth instalment, Italy requested its payment (€16.5 billion) on 22 September. On 9 October, Italy received €18.5 billion (€10 billion in grants and €8.5 billion in loans) under the third tranche of RRF funds, bringing the total funding received so far as part of the programme to over €85 billion.

2.10 PROJECTIONS

In our baseline scenario, GDP is set to grow by 0.7 per cent this year, 0.8 per cent next year, and 1.0 per cent in 2025. Inflation is projected to stand at 6.1 per cent this year on average and to fall to 2.4 per cent in 2024 and 1.9 per cent in 2025. The macroeconomic outlook, which has deteriorated significantly since the second quarter, will continue to be affected by the tightening of monetary and financial conditions and the weakness in global trade going into next year. The risks to growth are tilted to the downside, while the inflation outlook is balanced.

The assumptions underlying the new projections are less favourable than those made for the July projections

Compared with the macroeconomic situation in July, the current scenario incorporates a weakening in foreign demand, higher oil prices over the projection horizon and a further tightening of credit access conditions.

The prices of energy commodities are assumed to remain largely stable over the three-year forecast period, at much lower levels than in 2022; only oil prices are expected to exhibit a higher upward trend than in the July update (Table 11). Our scenario also factors in a significant slowdown in global trade this year, with an upturn in 2024 and 2025. In line

[19] The content of Decree Law 118/2023, which was subsequently repealed, was incorporated into Decree Law 104/2023 by the relevant conversion law.

[20] 'Act no. 182 relating to the Report on the Implementation of the National Recovery and Resilience Plan (NRRP), updated to 31 May 2023 (Doc. XIII, no. 1)' (only in Italian), report prepared by the Bank of Italy for the 4th Standing Committee of the Senate of the Italian Republic (European Union policies) and the 5th Standing Committee of the Senate of the Italian Republic (economic and budgetary policy), Senate of the Italian Republic, Rome, 12 September 2023.

with market participants' expectations, short-term nominal interest rates are assumed to increase further this year, stabilize next year and decline in 2025, while long-term interest rates are assumed to rise for most of the three-year period. Tighter monetary policy will likely translate into higher funding costs and more stringent conditions for access to credit, as signalled by the latest surveys conducted with banks and businesses (see the box 'Credit supply and demand since the start of monetary policy normalization'). Finally, the scenario considers the budget variance authorization request submitted to Parliament together with the Update to the 2023 Economic and Financial Document (NADEF) and the effects of the use of European funds under the Next Generation EU programme on the basis of the information currently available on the NRRP.

Table 11

The macroeconomic scenario assumptions for the main exogenous variables

	2022	2023	2024	2025
Potential foreign demand (1)	6.7	1.0	3.1	3.0
Dollar/euro (2)	1.05	1.08	1.06	1.06
Nominal effective exchange rate (1) (3)	1.1	-1.6	0.3	0.0
Crude oil prices (2) (4)	100.8	83.8	82.4	77.3
Natural gas prices (2) (5)	123.1	41.1	46.9	44.5
3-month Euribor (2)	0.3	3.4	3.6	3.1
1-year BOT yields (2)	0.9	3.6	3.4	3.1
10-year BTP yields (2)	3.2	4.4	5.1	5.3

Sources: Based on Istat and Refinitiv data as at 6 October.
(1) Percentage changes. – (2) Annual averages of crude oil futures prices at various quarterly maturities. – (3) Positive changes indicate a depreciation. – (4) Dollars per barrel of Brent crude oil. – (5) Euros per megawatt-hour.

GDP growth is projected to slow sharply, to just under 1 per cent

GDP is expected to grow by 0.7 per cent on average in 2023 (3.9 per cent in 2022), by 0.8 per cent in 2024 and by 1.0 per cent in 2025 (Table 12 and Figure 28). Following the unexpected contraction in the second quarter (see Section 2.1), GDP is projected to expand modestly in the second half of this year and at the beginning of next year, and to accelerate slightly starting from the spring of 2024. Growth will likely be affected by the negative effects of tighter financing conditions and weak international trade, which are expected to dampen the positive impulse stemming from the measures provided for under the NRRP and the gradual recovery in household purchasing power.

Table 12

The macroeconomic scenario

(percentage change on previous year unless otherwise indicated)

	October 2023 forecasts				Revisions compared with July 2023		
	2022	2023	2024	2025	2023	2024	2025
GDP (1)	3.9	0.7	0.8	1.0	-0.6	-0.1	0.0
Household consumption	5.0	1.3	0.9	1.0	0.0	-0.3	-0.1
Government consumption	0.7	0.0	0.0	0.5	-1.3	0.2	0.0
Gross fixed investment	10.1	0.5	0.3	1.3	-2.3	0.6	0.7
of which: in capital goods	8.1	3.6	-0.3	1.2	0.1	1.1	0.7
Total exports	10.7	0.4	2.4	3.1	-1.1	-0.4	0.3
Total imports	13.1	1.1	2.3	3.1	1.2	0.2	0.5
Change in stocks (2)	-0.7	0.1	0.1	0.0	1.0	0.1	0.0
Prices (HICP)	8.7	6.1	2.4	1.9	0.1	0.1	-0.1
HICP net of food and energy	3.3	4.6	2.3	1.9	0.1	-0.1	-0.1
GDP deflator	3.0	4.5	2.8	3.7	-0.9	0.2	0.2
Employment (hours worked)	4.5	1.7	0.5	0.6	-0.3	0.0	0.2
Employment (persons employed)	2.5	1.7	0.6	0.5	0.2	0.2	0.2
Unemployment rate (3)	8.1	7.6	7.6	7.6	-0.1	0.0	0.0
Current account of the balance of payments (4)	-1.5	0.3	0.8	1.2	-1.4	-1.4	-1.4

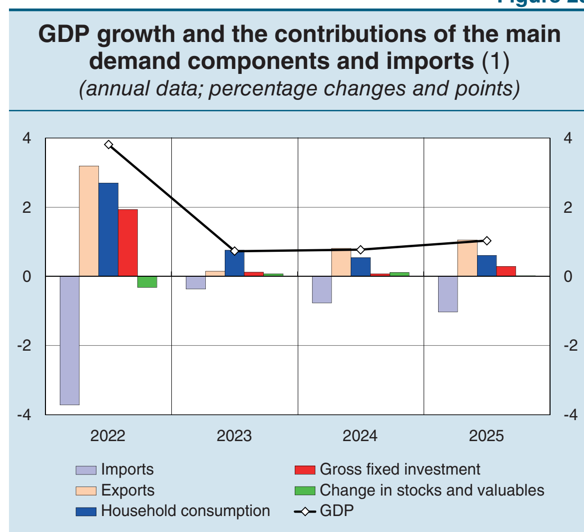
Sources: Based on Bank of Italy and Istat data. Forecasts for Italy, based on the data available at 6 October for the technical assumptions and at 10 October for the cyclical data.
(1) For GDP and its components: chain-linked volumes; changes estimated on the basis of quarterly data adjusted for seasonal and calendar effects. – (2) Includes valuables. Contributions to GDP growth; per cent. – (3) Annual average; per cent. – (4) Per cent of GDP.

Inflation is projected to fall significantly in the two years 2024-25

Harmonized consumer price inflation (HICP) is projected to average 6.1 per cent this year (against 8.7 per cent in 2022), and to subsequently decline to 2.4 per cent in 2024 and 1.9 per cent in 2025 (Table 12 and Figure 29). The

Figure 28

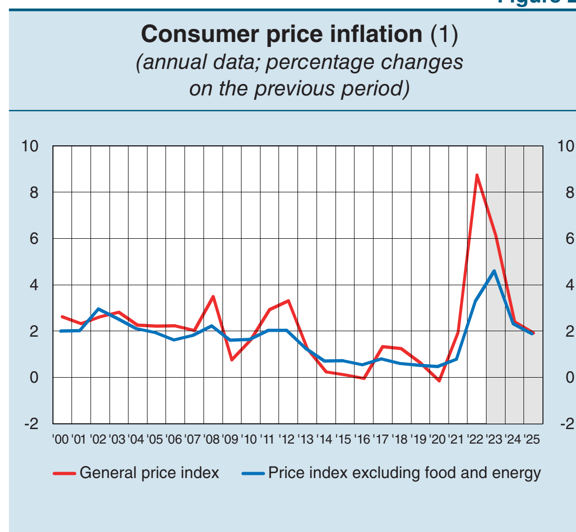
GDP growth and the contributions of the main demand components and imports (1)
(annual data; percentage changes and points)



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects.

Figure 29

Consumer price inflation (1)
(annual data; percentage changes on the previous period)



Sources: Based on Bank of Italy and Istat data.
(1) HICP. The shaded area shows forecast data.

downtrend mainly reflects a sharp drop in import prices, largely driven by falling energy commodity prices. Inflation excluding food and energy (core inflation) is set to remain high in 2023 (at 4.6 per cent on average) – mostly fuelled by the gradual pass-through of previous energy price increases – and to progressively slow over the next two years, to 2.3 per cent in 2024 and 1.9 per cent in 2025, thanks to the fall in the cost of intermediate goods and to the weakening in demand. Domestic inflation, as measured by the GDP deflator, is projected to rise to 4.5 per cent in 2023 (from 3.0 per cent in 2022) and to return to just over 3 per cent on average in the following two years. These developments are mostly attributable to trends in unit labour costs.

Labour demand is likely to display weak growth

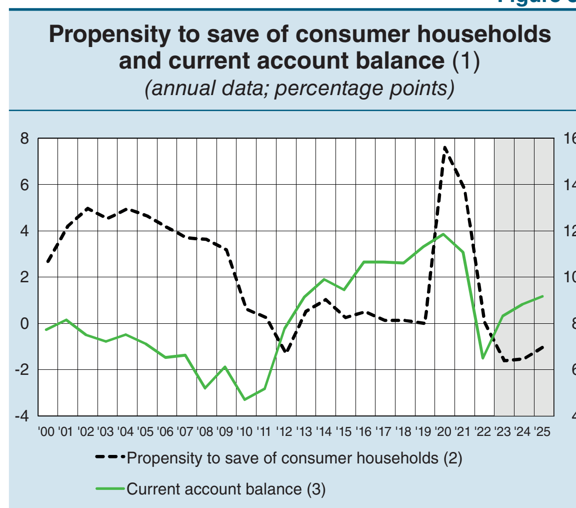
Growth in hours worked and in headcount employment looks set to moderate considerably in the second half of this year and to subsequently continue at a slower pace than GDP growth. The unemployment rate is expected to remain stable at 7.6 per cent over the three-year period, just below the average level for 2022 (8.1 per cent).

Consumption spending is set to grow slightly

Consumption is expected to continue to expand – supported by the progressive reduction in inflation and the gradual strengthening of wage growth – albeit at a slower pace than in the previous two years (5.1 per cent on average), when it benefited from the normalization of spending patterns following post-COVID reopenings. Household spending is set to grow by around 1 per cent per year throughout the three-year forecasting period. The household saving rate, which was 6.5 per cent in the first half of the year, is projected to increase slightly over the three years, while remaining below the average pre-pandemic level (Figure 30).

Figure 30

Propensity to save of consumer households and current account balance (1)
(annual data; percentage points)



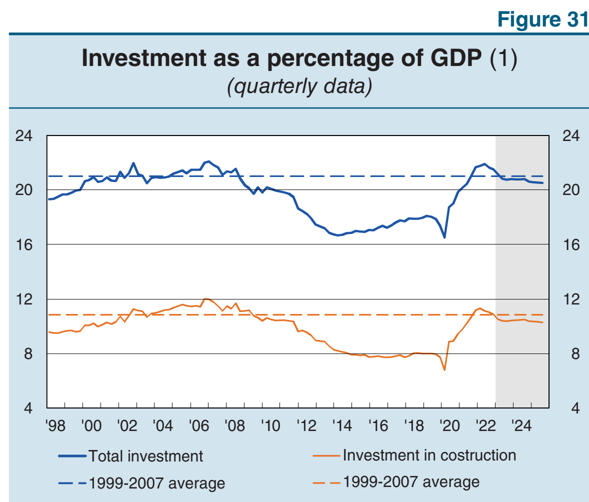
Sources: Based on Bank of Italy and Istat data.
(1) The shaded area shows forecast data. – (2) Right-hand scale. – (3) Per cent of GDP.

Investment is likely affected by the worsening financing conditions

The marked increase in the cost of loans and tighter credit access conditions are projected to weigh significantly on capital accumulation in the two years 2023-24, especially in the private sector, where investment is expected to fall by around 1 percentage point per year. This development is expected to be partly countered by the expansionary impulse of the measures provided for under the NRRP. On average, investment is expected to grow at a barely positive rate this year and the next, to then accelerate slightly in 2025. Overall, the total investment-to-GDP ratio is projected to decline slightly over the three-year period, remaining at a historically high level (Figure 31).

Figure 31

Investment as a percentage of GDP (1)
(quarterly data)



Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects. The shaded area shows forecast data.

The current account balance is expected to improve, mainly because of the smaller energy balance deficit

Exports will likely be affected by the sharp slowdown in foreign demand this year and accelerate in the next two years, to rates just below 3 per cent per year on average. Imports are projected to grow at a pace comparable to that of exports. The current account, which returned to surplus this year thanks to a significant reduction in the energy balance, is expected to rise further in the next two years (see the box 'The energy balance: recent developments and the outlook for 2023', *Economic Bulletin*, 3, 2023). As a result, Italy's net international investment position is set to strengthen (see Section 2.4).

The projections are revised slightly downwards for GDP growth and upwards for inflation

Compared with the projections published in July's *Economic Bulletin*, GDP growth has been revised downwards for 2023 and 2024 and has remained unchanged for 2025. The unexpected negative performance in the second quarter of this year is the main factor behind the revision for 2023 (-0.6 percentage points) and, through a carry-over effect, for 2024. Consumer price inflation has been revised upward by 0.1 percentage points for this year and the next and downwards by 0.1 points for 2025. The revisions for the two years 2023-24 stem to a large extent from the increase in energy commodity prices (see Section 1.1).

Table 13

Comparison with other organizations' forecasts for Italy
(percentage change on previous period)

	GDP (1)		Inflation (2)	
	2023	2024	2023	2024
IMF (October)	0.7	0.7	6.0	2.6
OECD (September)	0.8	0.8	6.1	2.5
European Commission (September)	0.9	0.8	5.9	2.9
Consensus Economics (October)	0.7	0.6	6.0	2.5
Bank of Italy (October)	0.7	0.8	6.1	2.4

Sources: IMF, *World Economic Outlook*, October 2023; OECD, *OECD Interim Economic Outlook*, September 2023; European Commission, *European Economic Forecast. Summer 2023 (Interim)*, September 2023; Consensus Economics, *Consensus Forecasts,* October 2023.
(1) The OECD's growth forecasts are adjusted for calendar effects; those of the European Commission and IMF are not. – (2) HICP. Consensus Economics forecasts refer to the consumer price index for the entire resident population (NIC).

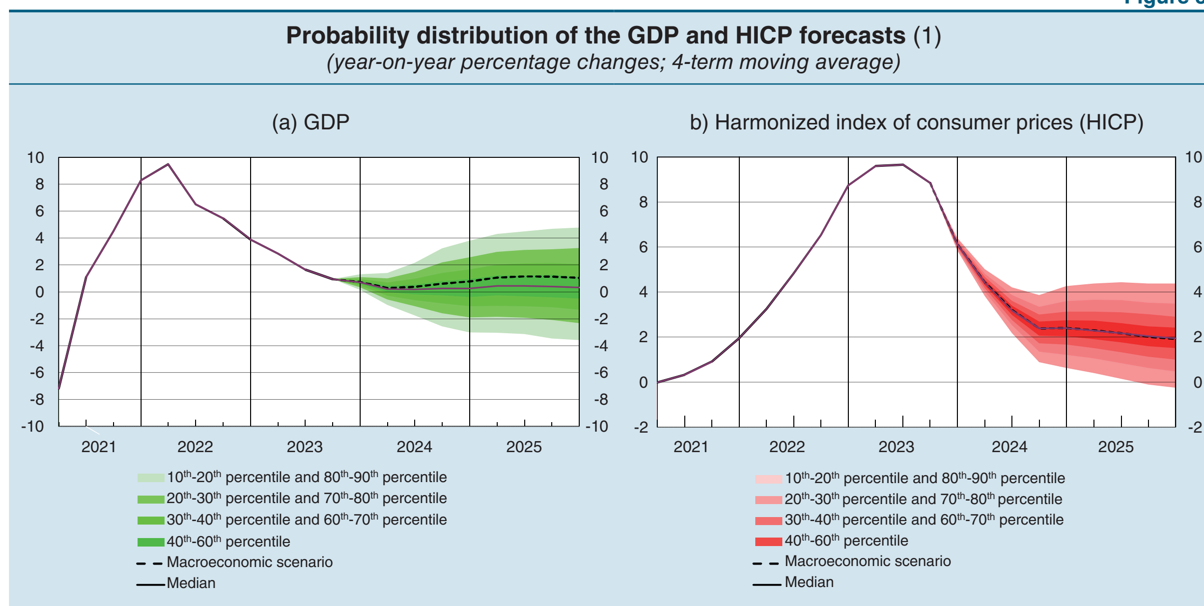
Our growth projections for 2023 and 2024 are close to the most recent estimates of the other leading forecasters (Table 13). Inflation projections differ slightly from those of the other forecasters for 2023 and are slightly lower for 2024.

The risks to growth are tilted to the downside, while the inflation outlook is balanced

The projections continue to be affected by high uncertainty, with risks to growth mainly tilted to the

Figure 32

Probability distribution of the GDP and HICP forecasts (1)
(year-on-year percentage changes; 4-term moving average)



(1) Calendar adjusted quarterly data. The probability distribution is graphed by percentile groups using fan charts, based on stochastic simulations made via random extractions from the shock distribution of the Bank of Italy's quarterly econometric model. The distribution takes account of asymmetric shocks to the equations that reflect the main risk factors according to the procedure described in C. Miani and S. Siviero, 'A non-parametric model-based approach to uncertainty and risk analysis of macroeconomic forecasts', Banca d'Italia, Temi di Discussione (Working Papers),758, 2010. The value corresponding to the fourth quarter of each year coincides with the average annual percentage change.

downside (Figure 32.a). International tensions and, in particular, those connected with the conflict in Ukraine and the extremely serious developments following the terrorist attacks in the Middle East constitute a major risk factor for global cyclical conditions, which could also be affected by weaker growth in the Chinese economy (see the box 'The crisis in China's real estate sector and the potential effects on the global economy'). Another element of uncertainty is the impact of a tightening of credit supply conditions in Italy and in the euro area as a whole, which could become more pronounced, with negative repercussions on the investment and consumption outlook. Conversely, the risks to inflation are balanced (Figure 32.b). Developments in energy and food commodity prices remain exposed to upside risks as a result of possible supply tensions on global markets; moreover, the pass-through of the fall in energy prices from the exceptionally high levels recorded in 2022 to the prices of other goods and services may be more gradual and partial compared with historical trends. Downside risks are instead associated with a more marked and lasting deterioration in aggregate demand than that incorporated in our scenario.