3.9 PROJECTIONS

The continuation of the sovereign debt crisis is affecting the outlook for growth

Since January, when we published our last macroeconomic projections, economic activity has continued to suffer from the sovereign debt crisis. Italy's GDP contracted in the first quarter of this year at a slightly faster pace than in the last part of 2011. The yields on Italian government securities, after falling sharply between January and March, rose part of the way back in May and June: the hypothesis adopted in this scenario is that in 2012-13 the spread between the yields on ten-year BTPs and German Bunds will remain close to the values observed in the first half of July (see the box "Technical assumptions and the international context"). It is assumed that the difficulties households and firms face in obtaining loans will gradually be overcome, with the credit market returning to normal in 2013; the strained conditions prevailing at the beginning of the year will nonetheless have subtracted about half a percentage point from growth in 2012. According to the latest IMF estimate, the expansion in world trade expected next year is more than a percentage point lower than projected in the January *Economic Bulletin*, owing both to the continuation of the European crisis and to the slowdown of the emerging economies. The projections take account of the measures contained in the spending review decree (see the box "Measures enacted under the spending review of July 2012").

TECHNICAL ASSUMPTIONS AND THE INTERNATIONAL CONTEXT

Our macroeconomic scenario is based on growth assumptions for GDP and world trade in line with those presented by the ECB in the June issue of its *Monthly Bulletin,* but updated to take account of the latest economic developments. World trade is expected to slow further in 2012, growing by 4 per cent and then by more than 5 per cent in 2013 – just below the average rate for the period 1999-2008. These assumptions are basically in line with the forecasts made recently by the main international organizations (the European Commission, the International Monetary Fund and the OECD).

The projections for oil prices, interest rates and exchange rates have been made on the basis of the prices recorded in the ten working days up to 13 July. On the basis of futures contracts, the price of a barrel of Brent crude oil is assumed to decline progressively over the forecasting horizon to $106.3 in 2012 and $97.5 in 2013.

Three-month interest rates, calculated on the basis of Euribor futures, are projected to fall below 1 per cent, both in 2012 and 2013; the average interest rates on twelve-month BOTs are expected to remain below 3 per cent. Long-term interest rates (corresponding to the yield on a basket of government securities with a duration of about six years) are expected to be close to 6 per cent on average in 2012-13 and the yield spread between the benchmark ten-year BTP and the corresponding German Bund to stay at around 450 basis points. On the currency markets, the assumption is that the bilateral exchange rates will remain unchanged at the average levels recorded in the ten working days up to 13 July; this implies an exchange rate of $1.27 to the euro on average in 2012, followed by a slight depreciation of the euro in 2013. Projections for Italy's public finances take account of the measures contained in the spending review decree passed at the beginning of July.

MEASURES ENACTED UNDER THE SPENDING REVIEW OF JULY 2012

Decree Law 95 of 6 July 2012 raises resources amounting to €4.4 billion in 2012, €10.3 billion in 2013 and €11.2 billion in 2014, almost wholly derived from expenditure cuts. These resources lower net borrowing in 2012 by around €0.6 billion, finance several unforeseen or non-deferrable expenses (including those related to the earthquake in Emilia-Romagna and, from 2014 onwards, the extension of exemptions from the pension reform) and offset the effects of the attenuation and postponement of the planned rise in VAT rates (€3.3 billion in 2012, €6.6 billion in 2013 and €9.9 billion in 2014). The decree lays down that the 10-per-cent and 21-per-cent rates will be raised by 2 points each starting in the third quarter of 2013 and then lowered by 1 point on 1 January 2014.

A first set of measures to curb spending aims to reduce inefficiencies in the procurement of goods and services by general government entities. Statistical analyses are used to estimate excess outlays by public entities, taking account of their special characteristics, and reference levels are assigned on the basis of which to make selective cuts in appropriations to them. For several categories of goods the obligation is established for government departments to make purchases using the instruments provided by the National Public Procurement Agency, Consip (via the regional purchasing centres); contracts stipulated in violation of this obligation are null, and the violation constitutes a disciplinary infraction and producing administrative liability.

A second set of measures concerns public sector employment. The decree envisages a reduction of at least 20 per cent in central government offices (excluding schools) and of at least 10 per cent in non-managerial staff. The possibility of receiving payment in lieu of untaken holidays is suspended. The maximum value of meal vouchers is reduced to €7.

Several measures aim to ensure more efficient use of public property and the lowering of rental costs. The State Property Agency will operate as a commissioning centre for the upkeep of State property. The size of public offices will be reduced through the introduction of reference parameters. A survey of the buildings of non-territorial public entities will be conducted to ascertain whether they can be utilized for central government purposes. The sale of lodgings owned by the Ministry of Defence will be accelerated. For the three years 2012-14 rents owed by government departments for existing contracts will not be updated based on the Istat price index; moreover, from 2013 these rents will be reduced by 15 per cent, without prejudice to the lessor's right of withdrawal.

Other measures concern public companies. Companies controlled directly or indirectly by general government entities that supply services almost exclusively to the same entities must be divested or wound up by end-2013. Measures are also introduced to limit direct procurement from publicly owned companies; in particular, starting in 2014, this will be permitted solely for purchases of goods and services for amounts of less than €200,000.

Also envisaged are significant expenditure cuts involving individual Ministries (around €1.5 billion in 2013 and in 2014), the endowments of several funds, and State transfers to local government entities (€2.3 billion in 2012, €5.2 billion in 2013 and €5.5 billion in 2014). The distribution of the cuts among the individual local government entities and the consequent changes to the Domestic Stability Pact targets must be agreed by 30 September; if no agreement is reached, the distribution will be made in proportion to the individual entities' expenditure on intermediate goods in 2011.

Provinces will be consolidated with the aim of cutting their number in half by end-2012. The criteria for the restructuring (relative to land area and population) must be fixed by the Council of Ministers within ten days after the decree's entry into force. The implementing provisions will be defined within the following forty days by the Council of Local Governments (or, failing which, by the regional bodies acting for or with local governments) in each ordinary statute region; the special statute regions will have six months to adapt to the decree. Finally, a legislative act proposed by the government will ratify the elimination and consolidation of the provinces. Until the restructuring process is complete, there will be a freeze on new permanent hires by the provinces. The decree transfers to the municipalities all the administrative functions currently assigned by law to the provinces and falling within the State's exclusive legislative competence. Once the consolidation procedure has been defined, the provinces' areas of competence shall be: 1) territorial planning; 2) environmental protection and utilization; 3) transport and roads. By 1 January 2014 ten metropolitan cities will be established (Rome, Turin, Milan, Venice, Genoa, Bologna, Florence, Bari, Naples and Reggio Calabria), and these ten provinces eliminated.

The decree also aims to limit outlays and curb spending inefficiencies in healthcare, including by fixing reference prices. In particular: following its entry into force, a 5 per cent reduction is envisaged in the prices and quantities of the goods and services purchased, excluding pharmaceutical products (for existing supply contracts, there is the possibility of renegotiation or withdrawal by the national health service in the event of deviations of more than 20 per cent between the prices applied and the reference prices). For pharmaceutical spending the obligatory discount for the national health service is increased, expenditure ceilings are lowered, and a levelling mechanism is introduced that distributes the cost of any overrunning on pharmaceutical expenditure by hospitals equitably between the regions and the pharmaceutical companies. It is expected that the share of expenditure on medical devices will be lowered to 4.9 per cent of the total allocation in 2013 and to 4.8 per cent in 2014; a reduction is imposed on purchases of healthcare services from accredited private entities in the form of a fixed percentage established by each region, in order to cut total annual expenditure by 1 per cent in 2012 and 2 per cent in 2013.

Effects of Decree Law 95 of 6 July 2012 on the general government consolidated accounts
(millions of euros)

	2012	2013	2014
SOURCES OF FUNDS	**4,392**	**10,330**	**11,234**
Revenue increases (A)	**600**	**1,200**	**1,500**
Changes to the Domestic Stability Pact – special statute regions	600	1,200	1,500
Expenditure cuts (B)	**3,792**	**9,130**	**9,734**
Changes to the Domestic Stability Pact – ordinary statute regions and local authorities	1,700	4,000	4,000
Rationalization and reduction of healthcare expenditure	900	1,800	2,000
Ministries	0	1,528	1,574
Other State departments and non-territorial entities	774	648	552
Purchases of goods and services	121	615	615
Reorganization of public sector workers	6	-202	144
Council of Ministers	25	50	50
Staff costs	88	25	480
Funding and elimination of public entities	175	463	463
Other	9	0	0
USES OF FUNDS	**3,789**	**10,314**	**11,207**
Revenue decreases (C)	**3,280**	**6,524**	**9,864**
Reduction of VAT	3,280	6,560	9,840
Other	0	-36	24
Revenue increases (D)	**509**	**3,790**	**1,343**
Extension of existing legislation and non-deferrable expenditure	509	2,740	103
Transfers to the Earthquake Reconstruction Fund	0	1,000	1,000
Safeguarding of workers from the effects of the pension reform	0	0	190
Other	0	50	50
Net change in revenue (E=A-C)	**-2,680**	**-5,324**	**-8,364**
Net change in expenditure (F=D-B)	**-3,283**	**-5,340**	**-8,391**
Change in net borrowing (G=F-E)	**-602**	**-16**	**-27**

Source: Based on official estimates in *Atti parlamentari*, Senato della Repubblica, No. 3396.

REVISION OF THE GROWTH PROJECTIONS WITH RESPECT TO THE PRE-CRISIS ESTIMATES: THE MAIN DETERMINANTS

The spreading of the sovereign debt crisis to Italy since the summer of 2011 has resulted in a continual, significant downward revision of the growth forecasts for the current year. In our *Economic Bulletin* of July 2011 we projected an increase of 1.1 per cent in Italy's GDP in 2012, in line with the forecasts of private analysts and the main international organizations. The projection contained in this edition of the *Economic Bulletin* is therefore about 3 percentage points lower than the figure we gave back then.

The Bank of Italy's econometric model can be used to isolate the contribution of the different factors to the deterioration in the economic situation. The main factors are: (a) the higher financing costs for the private sector due to the widening of the spreads on government securities; (b) the more difficult access to credit for firms, stemming largely from the strains in banks' wholesale funding; (c) the direct effects of the public finance adjustment packages; (d) the worsening of international conditions; and (e) the repercussions on consumption of uncertainty and the decline in household confidence. The table specifies the impact on GDP of each of these factors, calculated on the basis of their divergence from the assumptions made in last July's projections.

Projections of GDP growth in 2012: determinants of the revision between July 2011 and July 2012
(per cent and percentage points)

O.	**Projection, *Economic Bulletin*, July 2011**	**1.1**
A.	Increase in sovereign spreads	-0.4
B.	Firms' difficulty of access to credit	-0.6
C.	Public finance adjustment measures	-1.0
D.	Slowing of the world economy	-0.5
E.	Uncertainty and household confidence	-0.5
F.	Residual component	-0.1
G.	**Projection, *Economic Bulletin*, July 2012** ***(G=O+A+B+C+D+E+F)***	**-2.0**

According to the relations incorporated in the model, the worsening of the forecasting scenario is due largely to the rising cost and diminishing availability of credit, due in turn to the deepening of the sovereign debt crisis: if the yield spread of Italian over German government securities, bank interest rates and firms' conditions of access to credit had all remained at the levels obtaining last July, GDP growth would have been 1 percentage point better. The budgetary adjustment measures taken last year in order to avoid a further uncontrolled deterioration of conditions in the financial markets are estimated to have had a negative impact on demand amounting to 1 percentage point. An impact of 0.5 points is ascribable to the increase in uncertainty and the decline in household confidence, which amplified the fall in consumption. The slowdown in global economic activity and world trade is estimated to have subtracted another 0.5 percentage points from GDP growth.

The foregoing is an approximate breakdown and must in any case be interpreted with caution. The different channels considered separately here are, in reality, closely linked; moreover, by construction the exercise cannot take account of the events that would have occurred in the absence of the measures taken (the counterfactual scenario). For example, set against the direct effects indicated in the table, the fiscal adjustment measures probably helped to avert a widening of the spread on Italian government securities and a further restriction of credit availability, whose costs in terms of GDP would otherwise have been substantially greater. Likewise, the drop in consumption due to the fall in household confidence may also reflect the impact of other factors, such as the deterioration of the outlook for economic growth, the tightening of the financial constraints.

Italy's GDP will contract further in the second half of the year, albeit at a more moderate pace

In Italy it is expected that economic activity will continue to be marked by very weak domestic demand as a result of the worsening in credit conditions and the effects on disposable income of the measures adopted last year to consolidate the public finances. The recession is expected to continue, though easing in the second part of this year, and to end at the beginning of 2013. During that year, on the basis of the assumptions adopted in this bulletin, quarter-on-quarter growth will be only just positive; it could become more robust in 2014. In 2012 GDP appears set to contract by 2.0 per cent; in 2013, reflecting the previous year's contraction, year-on-year growth is likely to be still slightly negative (-0.2 per cent; Table 8).

Table 8

Macroeconomic scenario in Italy
(percentage changes on previous year, unless otherwise indicated)

	2011	2012	2013
GDP (1)	0.5	-2.0	-0.2
Household consumption	0.2	-2.5	-0.9
Government consumption	-0.9	-0.9	-1.9
Gross fixed investment	-1.2	-8.2	-0.0
Exports	6.3	2.4	5.9
Imports	1.0	-4.5	4.1
Change in stocks and valuables (2)	-0.6	-0.7	0.1
HICP (3)	2.9	3.0	1.8
Export competitiveness (4)	0.3	4.0	-0.2

Sources: Based on Bank of Italy and Istat 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) Contributions to GDP growth; percentage points. – (3) Harmonized index of consumer prices. – (4) Calculated by comparing the price of foreign manufactures with the deflator of Italian merchandise exports (excluding energy and agricultural products); a positive value indicates a gain in competitiveness.

The growth projections have been lowered

Our growth projections have been revised downwards compared with those presented in the January *Economic Bulletin*; to a large extent the revision reflects a less favourable outlook for domestic demand, for both investment and consumption, due to the deterioration in conditions in the labour market and the property market observed at the beginning of the year and the decline of confidence indices to low levels in the last few months. The effects of the recent earthquakes in some provinces of Emilia Romagna, although difficult to quantify, are estimated to contribute about a tenth of a percentage point to the contraction in GDP this year. The differences between the situation depicted here and that set out in last July's *Economic Bulletin* are larger; they are discussed in the box "Revision of the growth projections with respect to the pre-crisis estimates: the main determinants".

Exports will continue to sustain growth

Despite the slight downturn recorded in the first quarter of this year, exports are expected to grow again at a pace in line with that forecast for world trade; they stand to gain from an improvement in price competitiveness (more than 3.5 percentage points in the two years), which has benefited from the recent depreciation of the euro. Italy's sales abroad will be directed primarily to markets outside the EU, characterized by faster rates of growth.

Investment is held back by the weakness of demand and credit conditions

Investment activity will be affected by the still tight conditions in the credit market, although they are gradually improving, and the decidedly weak outlook for demand: investment in machinery and transport equipment is expected to fall by about 10 per cent this year, spending on construction by nearly 7 per cent. In 2013 spending on capital goods will again be held back by the high cost of financing and the decline in domestic demand. An important factor in the slowdown of investment will be the contraction of the residential construction market, marked by stagnant prices and a sharp drop in activity.

Consumption is dampened by households' declining disposable income and waning confidence

Households' spending will be braked by the effects of the fiscal adjustment packages on disposable income and the uncertain outlook for the labour market. Consumption is expected to contract significantly, by 2.5 per cent this year and almost 1 per cent next. Households will finance a part of their consumption this year by dipping into savings: the saving rate is expected to continue to decline on average in 2012-13.

Labour demand feels the recession

Labour demand, which grew slightly last year, is expected to begin to contract again, although less sharply than output. Employment will fall by just over 1 per cent in 2012 and then steady next year. Given significant expansion of the labour force, already observed in the first part of this year, the reduction in jobs will push up the unemployment rate, which is expected to exceed 11 per cent in 2013.

The external accounts will return to equilibrium …

Imports look set to fall by 4.5 per cent this year, reflecting the decline in domestic demand and particularly the reduction in investment. They should begin to expand again in 2013, driven by the acceleration of exports. Net exports are projected to make a positive contribution of 2.5 percentage points to the growth of GDP in the two years 2012-13 (Figure 29). The deficit on the current account of the balance of payments, which exceeded 3 per cent of GDP last year, is expected to be cut by half in 2012 and to fall to 0.5 per cent in 2013; this trend should be favoured by the expected improvement in the terms of trade, thanks to the assumed decline in crude oil prices inferred from futures prices.

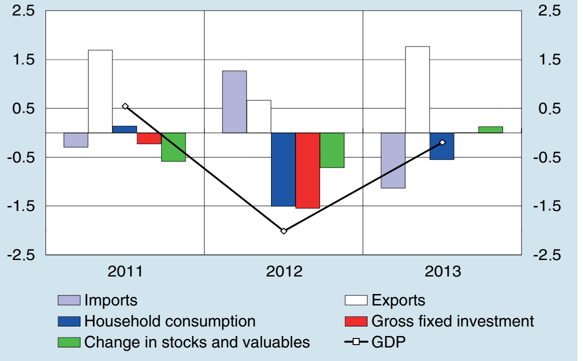
… and the public finance balances will continue to improve

The fiscal consolidation measures are expected to boost the primary surplus, which is projected to be nearly 3 per cent of GDP in 2012 and about 1 percentage point higher than that next year. Net borrowing is expected to fall below the 3 per cent threshold this year, fulfilling Italy's European commitments, and to continue to decline next year. The public debt/GDP ratio is likely to rise in 2012, owing not only to the fall in GDP but also to the large outlays for the assistance programmes for other euro-area countries (amounting to €17 billion already in the first half of the year). The increase in the primary surplus will ensure that the debt ratio will be practically stable in 2013 and will come down in the following years.

Figure 29

GDP growth and the contributions of its main determinants (1)

(percentage points)

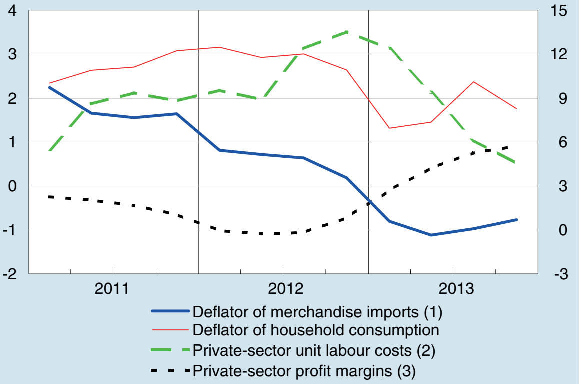


Sources: Based on Bank of Italy and Istat data.
(1) Adjusted for seasonal and calendar effects.

Figure 30

Main determinants of consumer price inflation

(percentage changes on year-earlier period)



Sources: Based on Bank of Italy and Istat data.
(1) Right-hand scale. – (2) Net of energy and agriculture; calculated as the ratio of compensation per standard employee labour unit to output per standard labour unit; output is value added at factor cost. – (3) Ratio of the deflator of value added at factor cost to unit labour costs in the private sector (net of energy and agriculture).

Consumer price inflation will fall below 2 per cent next year

Inflation gauged by the harmonized index of consumer prices (HICP) is expected to rise to an average of 3 per cent this year (from 2.9 per cent in 2011) and then to fall below 2 per cent in 2013. Inflation during the current year will reflect the major impact of the increases in indirect taxes (accounting for nearly 1 percentage point) and the rise in crude oil prices at the start of the year. A factor in its projected decline in 2013 is the postponement, under the spending review decree, of the increase in VAT rates originally scheduled for this October. Domestic inflation, measured by the GDP deflator, is expected to be just below 2 per cent this year and marginally above that level in 2013. Nominal earnings in the private sector are expected to grow at an average rate of about 2 per cent in the two years. The normal procyclical performance of productivity will be reflected in the rate of growth in unit labour costs, which is likely to increase during the rest of the year and then to fall back below 2 per cent in 2013. Profit margins are likely to contract this year and then to start growing again in 2013 (Figure 30).

Table 9

Other organizations' forecasts for Italy
(percentage changes on previous period)

	GDP (1)		Inflation (2)	
	2012	2013	2012	2013
European Commission (May)	-1.4	0.4	3.2	2.3
OECD (May)	-1.7	-0.4	3.3	2.3
Consensus Economics (July)	-1.8	-0.2	3.1	2.2
IMF (July)	-1.9	-0.3	2.5	1.8

Sources: European Commission, *European Economic Forecast – Spring 2012*, May 2012; OECD, *Economic Outlook* No. 91, May 2012; Consensus Economics, *Consensus Forecasts*, July 2012; IMF, *World Economic Outlook Update*, July 2012.
(1) The growth rates given in the OECD forecasts are adjusted for calendar effects; those of the European Commission and the IMF are not. – (2) HICP.

The differences with respect to other forecasters' assessments are modest

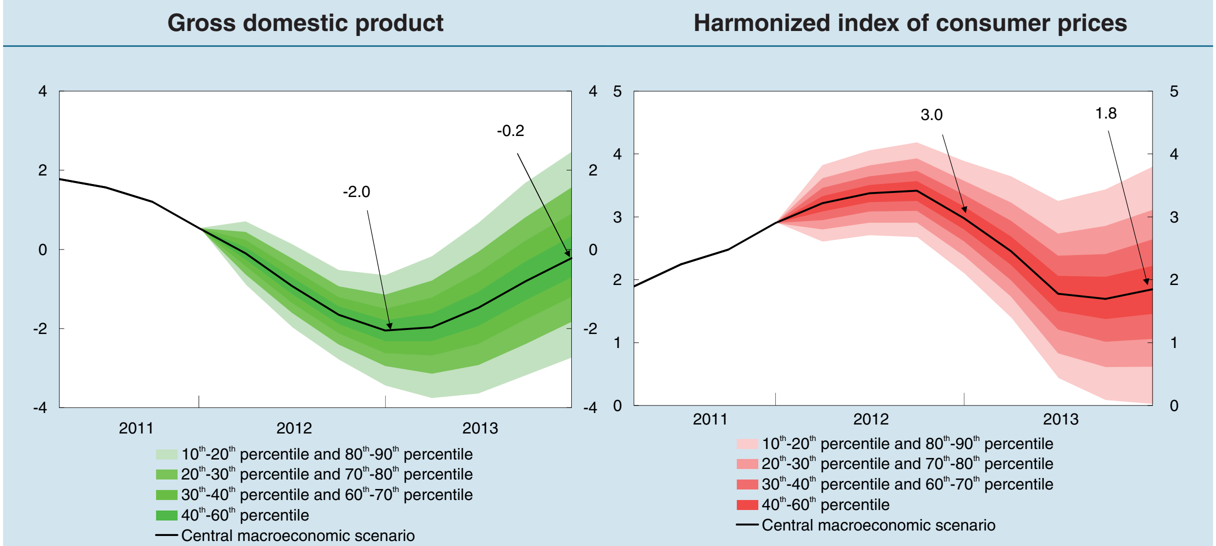
The growth and inflation forecasts recently published by the main international organizations do not differ substantially from those presented in this bulletin (Table 9). For the two years 2012-13 our projection for GDP is in line both with the average of the estimates by the private analysts polled by Consensus Economics in July and with that of the IMF, whose inflation forecast for this year, however, is more optimistic.

Favourable developments in managing the European crisis could help bring recovery

The uncertainty surrounding the medium-term prospects of the Italian economy is extraordinarily great (Figure 31) and is closely bound up with the developments of the sovereign debt crisis and its effects on interest rates, credit conditions, demand from Italy's European partners and the climate of confidence. Further progress in managing the crisis at European level and prompt implementation of

Figure 31

Distribution of probabilities of GDP and HICP projections (1)
(percentage changes on year-earlier period; 4-term moving average)



(1) The probability distribution is graphed, for percentile groups, by fan charts, based on stochastic simulations effected via random extractions from the shock distribution of the Bank of Italy quarterly econometric model. The figure shows year-on-year percentage changes of 4-term moving averages. The value corresponding to the fourth quarter of each year coincides with the average annual percentage change.

the decisions taken to date could help relieve the tensions on the financial markets, facilitating the return of the credit market to normality and assisting recovery in Italy and the rest of the area. Downside forecasting risks derive from the development of world trade, which has recently shown signs of slowing.

The macroeconomic scenario does not take account of the effects of the legislation for economic stimulus (the so-called growth decree) and for labour market reform. In our estimation, these chiefly structural measures can improve the outlook for growth mainly in the medium term.