Appendix C.
Italy: austerity at any cost?

After four consecutive quarters of recession, Italy has well and truly sunk back into crisis. In 2011, the positive contribution of foreign trade had helped to offset falling domestic demand and inventory reductions. Since the last quarter of 2011, however, the decline in imports was insufficient to offset a reduction in investment and in private consumption. This situation, which is mainly due to the ongoing fiscal consolidation, is not about to change. In fact, Prime Minister Monti intends to stay the course of austerity, which should allow the country to drop below the threshold of a 3 % budget deficit in 2012. This recovery will become more difficult in late 2012 and 2013, however, as the prospects for external demand are being undermined in a euro zone that is everywhere subject to austerity. Fiscal discipline will not permit the country's return to growth in the coming months, making it all the more difficult to reduce the deficit. Despite a highly negative fiscal impulse (-3.2 points and -2.1 points in 2012 and 2013 respectively), the government deficit will shrink by only 2.5 points in two years, to 1.3 % in 2013. The only source of hope for the country is the decision of the European Central Bank to launch the Outright Monetary Transactions (OMT). This programme should lead to lower long-term bond rates, thus lightening the burden of interest on the public debt and allowing the country to ease its consolidation.

With regard to households, private consumption declined in the first half of 2012 under the combined impact of a rise in precautionary savings, a sharp decline in gross disposable income and a tightening of credit conditions. The annual decline in real gross disposable income, which has lasted since 2007, is due to several factors: a steep rise in unemployment, combined with a freeze on public sector salaries until 2013, together with losses in the value of financial assets, and finally an increase in taxes and charges associated with deficit reduction measures. For instance, the reintroduction of the property tax (IMU) in 2012 and hikes in electricity, natural gas and fuel prices will squeeze incomes. In addition, the 2 point increase in VAT, originally scheduled for October 2012, was postponed to July 2013 and will hit consumption. Inflation is still rising (3.6% in the second quarter of 2012 yoy), with a sharp increase in transport fares and housing prices in the first half of 2012. Up to the end of 2011, the savings rate had acted as a shock absorber, as it fell from 16.5% of gross disposable income (GDI) in 2004 to 12% in 2011, thus helping to sustain household consumption. However, in the last quarter of 2011, the savings rate increased and since then has stayed at 12.3% of GDI, which is leading to a drop in consumption. Credit conditions continue to be poor: in the first half of 2012, growth in bank loans continued to slow for households (+0.1% in July 2012 yoy), and companies were facing a credit crunch (-2.1%).

On the employment front, the expansion of the labour force since mid-2011 due to pension reform (+3% yoy in the second quarter of 2012), combined with a sluggish job market, has contributed to a sharp increase in unemployment, with 700,000 more unemployed in the space of a year, a rise that was particularly marked among young people. We anticipate continued growth in the labour force in the second half of 2012 and 2013, due to pension reform and a return to the labour market of inactive people whose disposable income has eroded. As a result, the unemployment rate will continue to mount, reaching 11.7% in late 2013.

As for business, Italy is still currently shedding its excess capacity in less competitive sectors, as is shown by the rising number of bankruptcies. The decline in total employment has not led to higher productivity due to a larger fall in added value. The rate of profit of Italian companies reached a low point in the first quarter of 2012, and the investment rate has returned to its 2009 level. The industrial production index has continued to fall. The construction sector has been hit hardest: the production index in this sector is back to its 1999 level. Furthermore, business margins worsened for companies across all sectors. Our forecast anticipates a further deterioration in productivity and in the level of productive investment, under the constraints of weak domestic demand and sluggish external demand. Adjustments will thus continue, with gross fixed capital formation (GFCF) declining significantly in 2012 and 2013.

The contribution of foreign trade remains the only positive component of growth. This dynamism stems more from a collapse in imports since early 2011 due to the collapse of domestic demand than it does from the dynamism of exports, although the latter did grow in the second quarter of 2012. In late 2012 and in 2013, imports will continue to shrink, with net exports thus attenuating the recession to some extent. It is essentially the emerging countries that are contributing to growth (14% of Italian exports), as the euro zone countries (56% of Italian exports) are also being hit by the slowdown in domestic demand and by budget constraints.

The ongoing fiscal adjustment is deepening the gloom for Italy. With a debt of 1,905 billion euros in 2011 (120% of GDP), the country must pay a high amount of interest (5.3% of GDP projected in 2012), which makes it difficult to reduce the deficit even in the presence of a structural primary surplus. After the three austerity plans of July, August and December 2011 to save 145 billion euros over four years, the Law of 4 August 2012 (DL 52/2012) is aimed at compensating for the deterioration in the country's growth prospects through greater austerity, with 26 billion euros of additional savings from 2012 to 2014. This is to be accomplished solely by cutting public spending (civil service, health, public administration and higher education) and by selling off some public property assets.

The government's goal of achieving a deficit of 1.7% of GDP in 2012 and 0.5% in 2013 will not be met in the absence of additional austerity measures, given the expected magnitude of the recession in comparison with government projections.

A strongly negative national fiscal impulse (-3.2 points in 2012 and -2.1 points in 2013) will exacerbate the recession, thus adding to the external impetus, which is also very negative for 2012 and 2013 (-1.3 points in 2012 and -1.2 points in 2013). As a result, despite the current budgetary efforts and in the absence of additional measures, the Italian deficit will still come to 2.5% of GDP in 2012 and 1.3% of GDP in 2013. If the government wants to fulfil its commitment despite all this, it would need to pass a new austerity plan of 9.5 billion euros in 2012 and 10 billion in 2013.

Table C. OFCE, ECLM, IMK macroeconomic forecasts

Italy

%	2010	2011	2012	2013
GDP	1.8	0.5	-2.1	-1.5
Private consumption	1.2	0.2	-3.4	-2.6
Investment	1.7	-1.2	-8.4	-5.2
Public consumption	-0.6	-0.9	-0.7	-0.3
Exports	11.4	6.3	0.8	1.8
Imports	12.4	1.0	-7.7	-1.5
Contribution to growth				
Internal demand	0.9	-0.3	-3.8	-2.5
External trade	-0.4	1.5	2.6	1.0
Inventories	1.3	-0.7	-0.8	0.1
Unemployment rate	8.4	8.4	10.7	11.6
Inflation	1.6	2.9	3.5	2.1
Public deficit % GDP	-4.6	-3.9	-2.5	-1.3
Fiscal impulse % GDP	-0.4	-1.2	-3.2	-2.1
Public debt % GDP	118.7	120.0	126.5	125.6
Current account % GDP	-3.5	-3.5	-2.4	-1.7
Unit labour costs	-0.8	1.2	2.7	1.1

Source: National accounts, Eurostat, OFCE, ECLM, IMK.