ufficio parlamentare di bilancio

Summary[*]

International conditions are conducive to the continuation of the Italian economic recovery. Global growth has consolidated, impacting developments in world trade and the price of oil. The appreciation of the euro has softened the inflationary impact of oil prices. Inflation in the euro area therefore remains low, also reflecting low wage pressures. Monetary conditions remain expansionary.

In Italy, economic developments remain positive, despite a temporary easing between the end of 2017 and the beginning of 2018. Surveys of industrial firms show that confidence has returned to pre-crisis levels. The expansion of investment has benefited, buoyed by improved financial conditions and tax incentives. Consumer spending has gradually recovered, reflecting the effects of employment growth on disposable income. Exports have continued to grow rapidly, driven by the expansion of world trade. The growth in exports has been accompanied by a robust expansion of imports, fuelled also by the demand for capital goods. Inflation remains modest

With this report, the PBO begins to present its own medium-term forecasts for Italy. The forecasts, which extend to 2019, highlight the continuation of growth. GDP is estimated to have increased by 1.4 per cent in 2017 (unadjusted for the number of working days) and is projected to grow by 1.4 per cent in 2018 before easing to 1.2 per cent in 2019. Activity should be driven by domestic demand, in particular by investment. Export growth is expected to slow, partly hampered by the appreciation of the euro. The slowdown in GDP growth next year reflects a deceleration in consumption due to the increase in indirect taxes included in the budget package incorporated in the PBO forecasting scenario.

Despite the appreciable growth in employment, the unemployment rate is projected to decline only gradually owing to an the increase in the labour supply; the large pool of long-term unemployed, who are more difficult to reintegrate in production activities, should also have an impact. Inflation is expected to remain moderate in 2018, before rising in 2019 in reflection of higher indirect taxes and more buoyant wage growth. These factors will be partly offset by the deflationary impulses of the fall in the price of oil and a further strengthening of the euro.

The PBO forecast is exposed to a number of risk factors. It assumes the containment of geo-political tensions, the gradual normalisation of monetary policies, the absence of abrupt corrections in financial markets and any shift towards protectionist policies. Adverse developments on these fronts would affect the outlook for global and Italian growth.

[*] *Prepared by the Macroeconomic Analysis Department. Information updated to 25 January 2018.*

The international environment

World economic growth continues

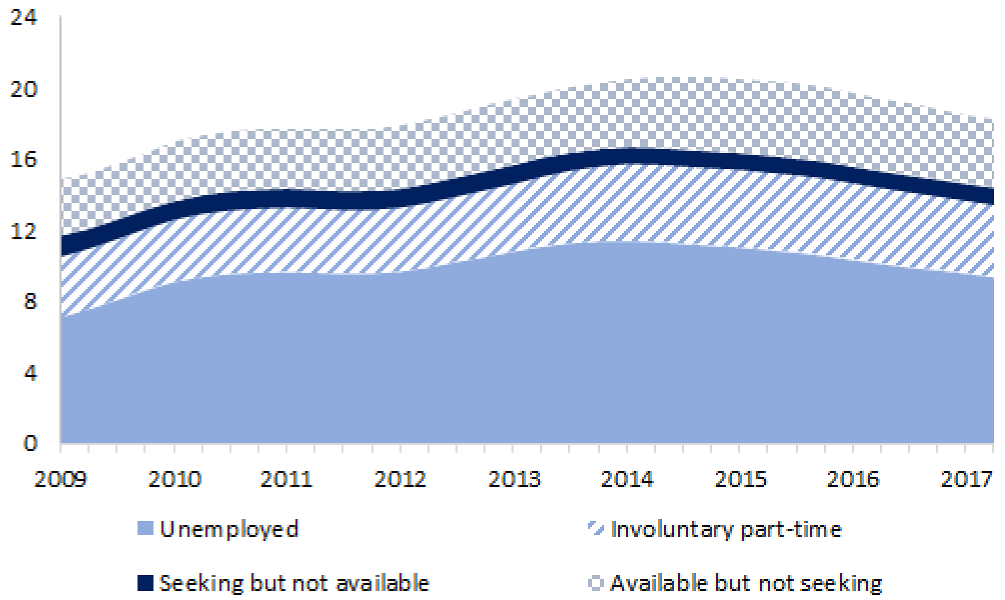
The signals from the world economy have confirmed the continuation of the favourable economic conditions seen in recent months. The expansion of global output has impacted the growth of international trade and the prices of raw materials, notably oil. The continuing expansionary stance of monetary policies is contributing to the positive developments, although the United States and the United Kingdom have begun to gradually adjust official interest rates upwards and the euro area has trimmed the scale of its quantitative easing. In the foreign exchange market, the stronger economic growth in the single currency area and the expectations for a gradual normalisation of monetary policy have fostered the strengthening of the euro.

Recent economic developments

In the United States, growth in the third quarter was robust (+3.2 per cent year on year), driven mainly by consumption. Total investments also made a substantial contribution to the expansion, although this was partly due to stock-building. The unemployment rate fell very low (4.1 per cent in December), without however engendering significant wage strains. Despite the prolonged phase of economic growth, the labour force participation rate is still far from the peak registered in 2007. While this gap partly reflects an aging population, the additional scope for an increase in labour market participation helps contain pressures on wages. Room for further improvement in economic conditions is also present in industry, where despite the long recovery capacity utilisation is still below the long-term average. Looking ahead, most business surveys suggest that favourable conditions will continue, while estimates from the Federal Reserve system point to a growth rate of over 3 per cent (annualised) in the final part of 2017 and early 2018. The recent tax reform adopted by the US administration should provide an additional temporary boost to the expansion, although it will cause the public finances to deteriorate and increase the external deficit.

The euro area continued to post solid growth in the third quarter (+0.7%), substantially in line with previous quarters. The recovery, driven by both foreign and domestic demand, has spread to the various economies, with Germany and Spain continuing to expand at a relatively faster pace. As a result of the strong economic conditions, the average euro-area unemployment rate declined further, to 8.7% in November. However, underemployment remains significant (in addition to the unemployed, this also includes involuntary part-time employees and inactive workers who are available to work) at around 18 per cent of the expanded labour force (including potential workers; Figure 1).

Figure 1 – Unemployment, underemployment and potential labour force (1)
(4–quarter moving average - percentages)

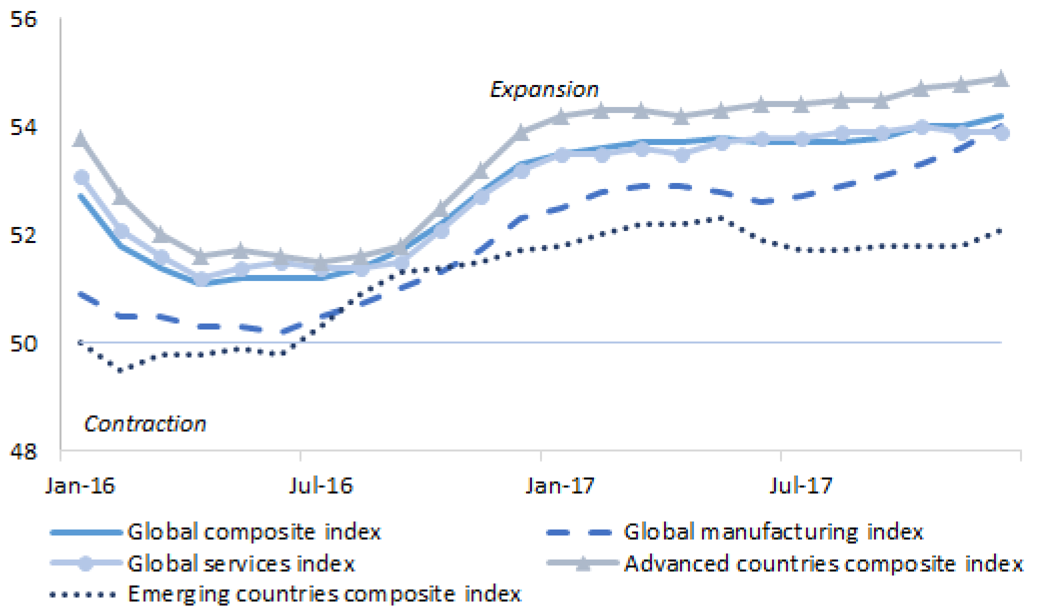


Source: based on Eurostat data.
(1) The percentages are given in terms of the effective labour force (employed and unemployed) plus the potential additional labour force (seeking work but unavailable and not seeking work but available).

Japan and China continue to grow rapidly thanks to the support of monetary and fiscal policies, while the other emerging economies are also expanding. More uncertain and moderate growth has been registered in Russia, Brazil and Mexico.

The short-term forecasts for individual countries, as well as global indicators, suggest a continuation of the expansion at a pace similar to that observed most recently. The Purchasing Managers' Index (PMI) points to a continuation of the expansion in the coming months at a pace comparable to recent developments (Figure 2).

Figure 2 – JP Morgan Global PMI indices (1)
(3-month moving average)



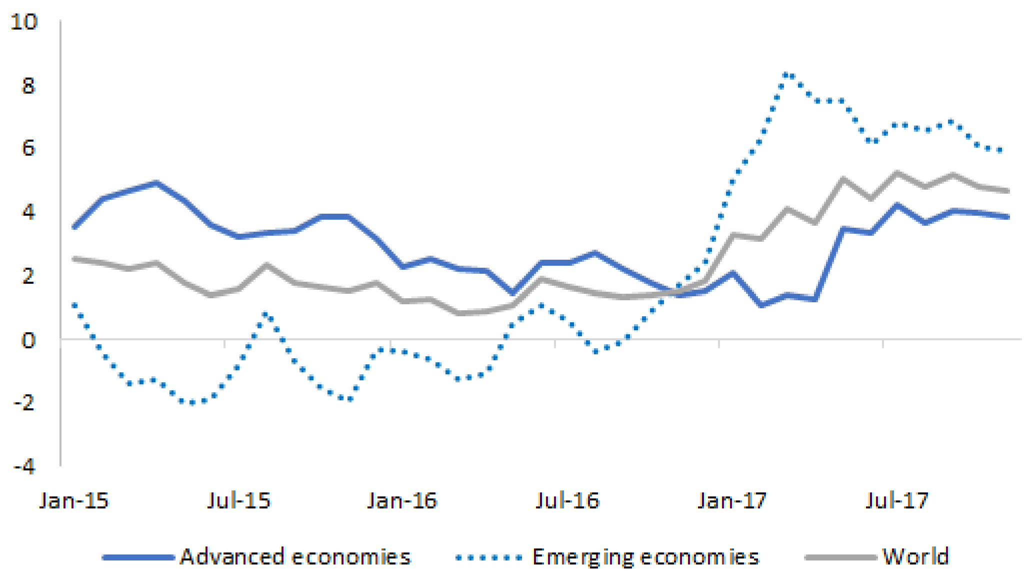
Source: Thomson Reuters.
(1) Confidence indicators based on the assessments expressed by corporate purchasing managers. A value of more than 50 indicates an expansion.

The recovery in world trade continues

Since last year, world trade has begun to grow rapidly again. The recovery has involved both the advanced countries and the emerging economies (Figure 3), resulting in overall trade growth averaging more than 4.5 per cent in 2017. Expectations for the coming year suggest that growth will continue along the path of expansion.

The trade front however is clouded by protectionist inclinations on the part of the US administration. The recent decision to impose tariffs on imports of solar panels and washing machines (30 per cent for the former and 50 per cent for the latter, with exemptions and reductions up to a certain threshold) will probably have a limited impact on trade, but does represent a signal of the world's largest economy's approach to trade. The risk is that such measures could prompt retaliation by trading partners, potentially harming the growth in world trade.

Figure 3 – Growth rate of imports
(annual percentage change in 3-month moving average)



Source: based on Thomson Reuters data.

The world economy in recent IMF forecasts

In the regular January update of its forecasting scenario, the International Monetary Fund (IMF) revised upwards its projection for world growth in 2018 and 2019 (Table 1). The revision for both years was equal to two-tenths of a percentage point, bringing the forecast for global growth to 3.9 per cent. According to IMF economists, about 50 per cent of the greater growth is attributable to the upwards revision of estimates for the United States (to 2.7 and 2.5 per cent in 2018 and 2019 respectively, with an increase of four-tenths of a point in the first year and six-tenths in the second compared with the organisation's previous forecasts), a consequence of the tax reform approved towards the end of 2017. More specifically, the IMF expects that reform to act as an incentive to accelerate investment spending as a result of the temporary nature of a number of tax relief measures. The forecasts for the euro area were also revised upwards (three-tenths of a point each year), and now stand at 2.2 and 2 per cent. By contrast, the update for the emerging markets confirmed the previous forecasts (4.9 and 5 per cent in 2018 and 2019 respectively). Along with the correction of the forecasts for world GDP growth, the IMF made an even larger upwards revision of world trade, which is now expected to expand by 4.6 per cent this year (six-tenths of a point more than in October) and 4.4 per cent in 2019 (five-tenths more).

Table 1 – IMF forecasts
(percentage change and differences in percentage points)

	WEO update January 2018		Difference with WEO October 2017	
	2018	2019	2018	2019
World GDP	3.9	3.9	0.2	0.2
Advanced economies	*2.3*	*2.2*	*0.3*	*0.4*
United States	*2.7*	*2.5*	*0.4*	*0.6*
Euro area	*2.2*	*2.0*	*0.3*	*0.3*
Emerging economies	*4.9*	*5.0*	*0.0*	*0.0*
World trade	4.6	4.4	0.6	0.5

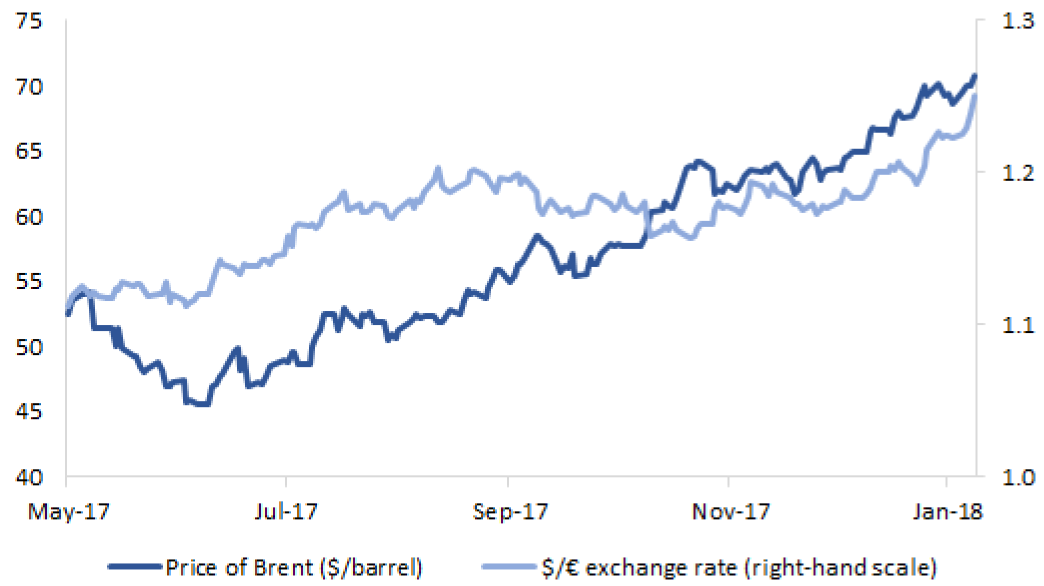
Source: IMF, World Economic Outlook update (WEO update), January 2018.

Oil prices rise and the euro appreciates

Strong demand and the parallel renewal of the agreement among the OPEC countries and Russia to curtail the supply of oil for all of 2018 sustained oil prices, which in January returned to close to $70 a barrel (for Brent), its level at the end of 2014 (Figure 4). While robust demand and weak supply tend to increase the price of oil, that rise also tends to encourage the production of shale oil, which has a higher break-even price, thereby stimulating domestic production in the United States, exerting a consequent downwards pressure on prices. Developments on forward markets point to the stabilisation of oil prices in 2018 and a subsequent decline towards $63 a barrel in 2019.

From mid-December the euro began to strengthen against the dollar (the appreciation in January came to about 2.5 per cent on the previous month and 14.5 per cent year-on-year). This rise reflected the good economic performance in the euro area and expectations of a gradual normalisation of monetary policy, as well as a decline in political uncertainty in the area. Forward prices suggest this process will continue, with a gradual strengthening of the euro to about $1.30 at the end of 2019.

Figure 4 – Oil prices and dollar/euro exchange rate

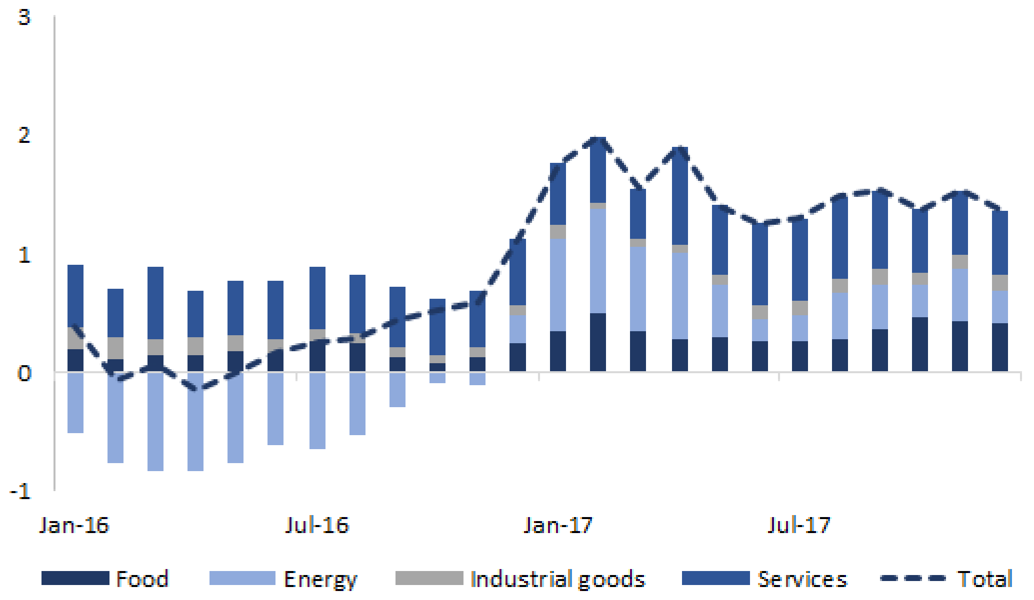


Source: based on Thomson Reuters data.

Euro-area inflation remains weak and the ECB maintains expansionary stance

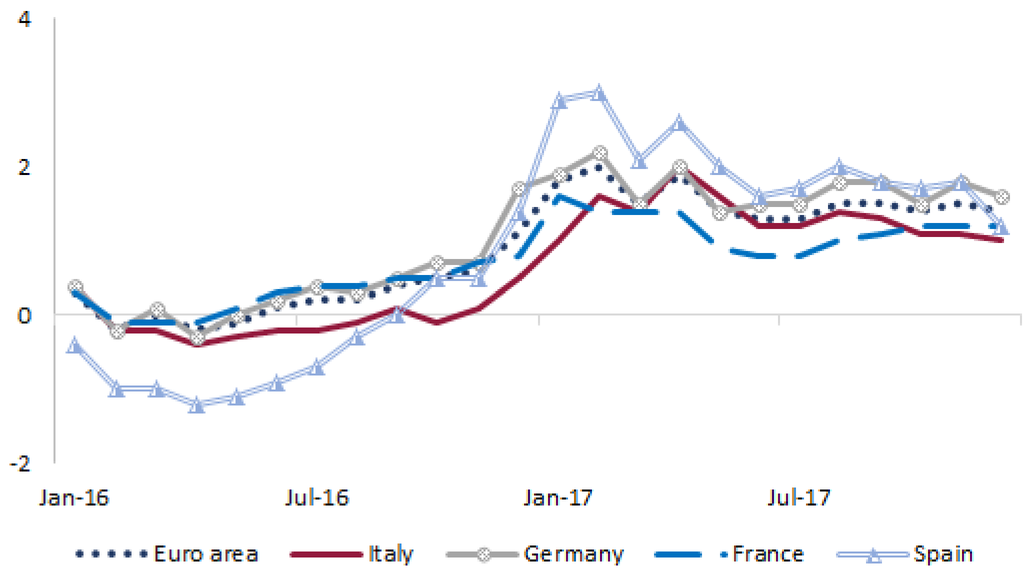
In December, inflation in the euro area declined slightly to 1.4 per cent (1.5 per cent in November, Figure 5). The smallest changes were seen in the prices of industrial goods and of services, while those of food and energy products rose at a pace of more than 2 per cent. For the latter, the appreciation of the euro against the dollar partly attenuated the sharp rise in original prices. Core inflation remained stable in the final three months of the year at below 1 per cent, lower than in the summer. The distribution of inflation rates in the main economies shows that as from the middle of last year, rates in Italy and France have been lower than the euro-area average, while that in Germany has been above that level (Figure 6). Inflation in Spain, which had risen significantly in the early months of 2017 thanks in part to a comparatively larger impact of the increase in oil prices, converged towards the level in France at the end of 2017, remaining slightly higher than inflation in Italy. The persistent moderation of prices is reflected in the formation of expectations: the inflation expectations implicit in inflation swaps show a weak rising trend, especially at medium and long term (Figure 7).

Figure 5 – Inflation in the euro area
(annual percentage changes and contributions)



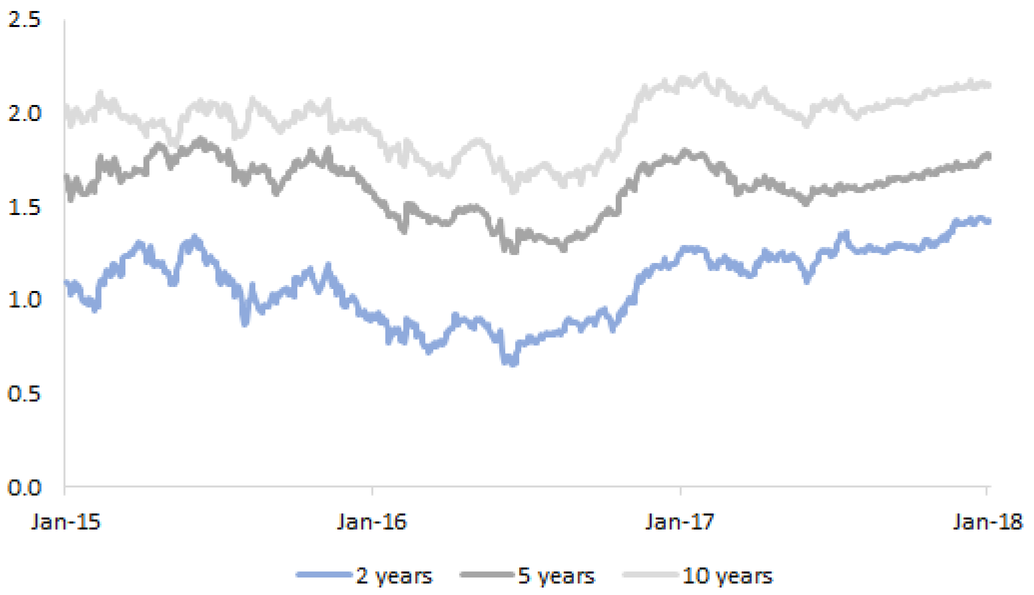
Source: based on Thomson Reuters data.

Figure 6 – Inflation in the main euro-area countries
(percentage changes)



Source: Thomson Reuters.

Figure 7 – Inflation expectations in the euro area
(inflation linked swaps)



Source: Thomson Reuters.

In this environment, the ECB's monetary policy stance has remained expansionary in order to support the recovery and boost inflation. As announced last October, from January purchase of securities under the asset purchase programme have been cut in half to €30 billion a month. The programme will continue until at least September this year, when it will be reassessed in the light of developments in inflation. The assets already held by the Eurosystem will in any case be rolled over at maturity for an extended period of time. The ECB also reaffirmed that official rates will remain at their current levels past the end of the asset purchase programme.

The Italian economy

The recovery continues

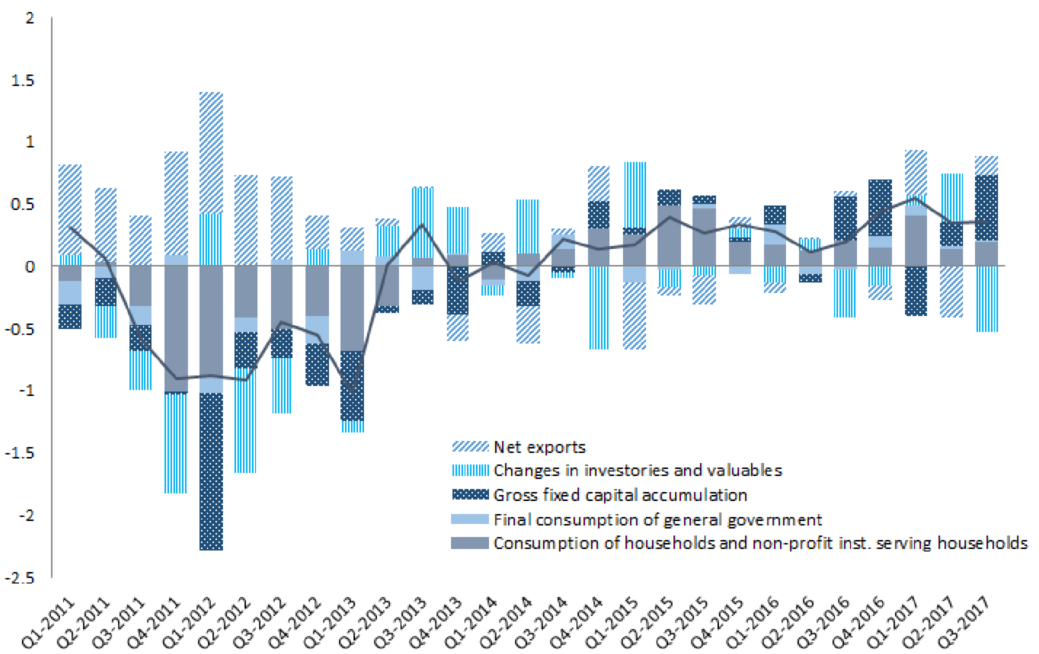
GDP growth picked up in the third quarter of 2017 (+0.4 per cent compared with April-June; +1.7 per cent year-on-year), after a slight period-on-period deceleration in the previous quarter. According to the most recent national accounts data released by Istat last December, that increase - the thirteenth in a row - brought growth already achieved in 2017 to 1.4 per cent (adjusted for calendar effects).

On the supply side, the increase in activity in the third quarter mainly reflected the recovery in industry excluding construction (+1.6 per cent on the previous period) and, to a lesser extent, construction (+0.4 per cent). By contrast, services were virtually unchanged (+0.1 per cent), whereas agriculture contracted (-3.6 per cent). As regards the components of demand (Figure 8), the contribution of domestic spending was positive at about 0.7 percentage points (0.2 points attributable to household consumption and 0.5 points to investment). Conversely, stock-building subtracted about half a percentage point of growth. Thanks to the expansion of world trade, foreign demand made a positive contribution of about 0.2 percentage points, the result of a larger period-on-period increase in exports (+1.6 per cent) than imports (+1.2 per cent).

Consumption increases...

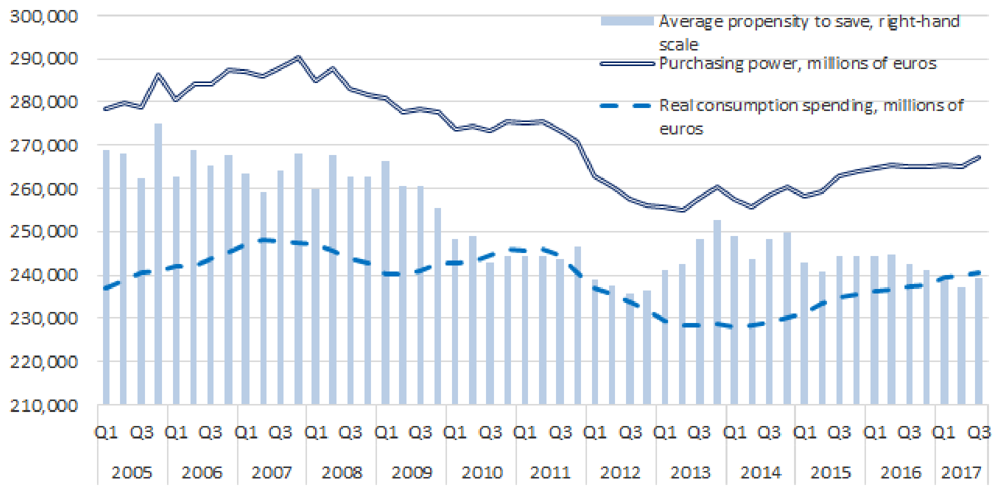
Following the deceleration in the second quarter, consumption strengthened in the third (+0.3 per cent on the previous period), mainly driven by purchases of durables and services. The increase in consumption spending reflected the good performance of household purchasing power (+0.8 per cent on the previous period in the third quarter), as developments in the labour market remained positive. Households' average propensity to save increased compared with the previous quarter, although its level (9.9 per cent of disposable income) was still about one percentage point lower than the average in 2016 and more than four percentage points lower than the average in the pre-crisis period (Figure 9).

Figure 8 – Change in GDP on previous quarter and contributions of the components of demand
(percentage changes and contributions in percentage points)



Source: based on Istat data.

Figure 9 – Household income, consumption and saving
(millions of euros and percentage shares)



Source: based on Istat data.

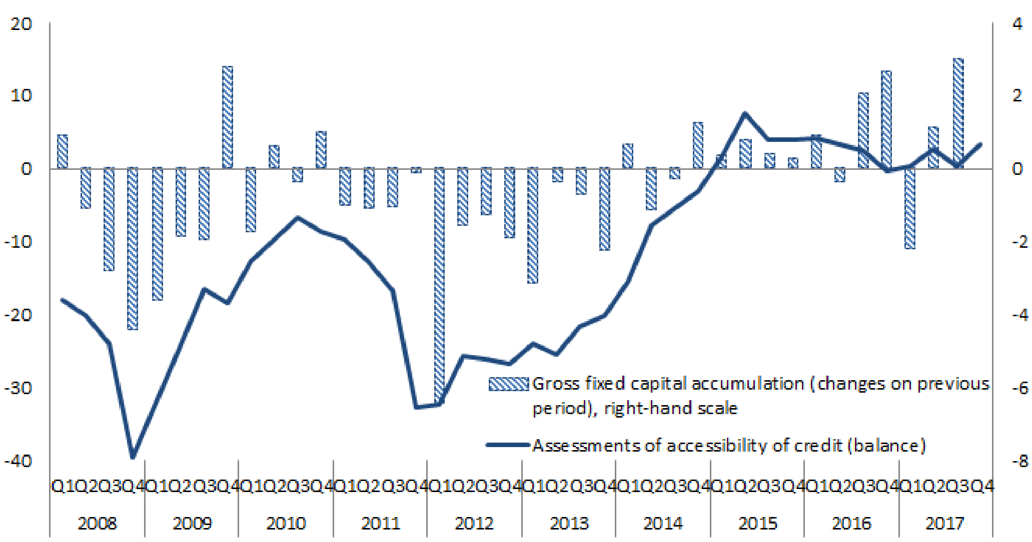
The developments in consumption benefitted from the robust rise in household confidence, both with regard to assessments of the general economic situation and personal circumstances. The most recent survey data show a sharp improvement in assessments of personal financial circumstances and the economy as a whole. The more favourable climate of confidence, in an environment of historically low levels of economic uncertainty, could continue to lend a positive impulse to household spending plans in the coming months.

...and investment jumps

Capital accumulation continued in the third quarter, following the path of recovery that began in the second half of 2014, jumping by 3 per cent from the average for April-June. The growth in gross fixed investment was driven by the strong performance of machinery and equipment (+6 per cent) and the expansion in transport equipment (+1.9 per cent). Both types of business expenditure continued to benefit from tax relief in the form of super- and hyper-depreciation for purchases of machinery. Weaker signs came from investment in construction, which expanded only slightly (+0.3 per cent).

The recovery in investment is expected to have continued in the final part of 2017. Despite a decline in profits as a percentage of value added in the third quarter compared with the second quarter, in the summer the investment rate (i.e. the ratio between gross fixed capital accumulation and value added at basic prices) continued the rise that began at the end of 2016, buoyed by firms' increased scope for self-financing and favourable credit conditions (Figure 10). Nevertheless, despite the recent recovery, the investment rate for industry is more than two percentage points lower than its pre-crisis level.

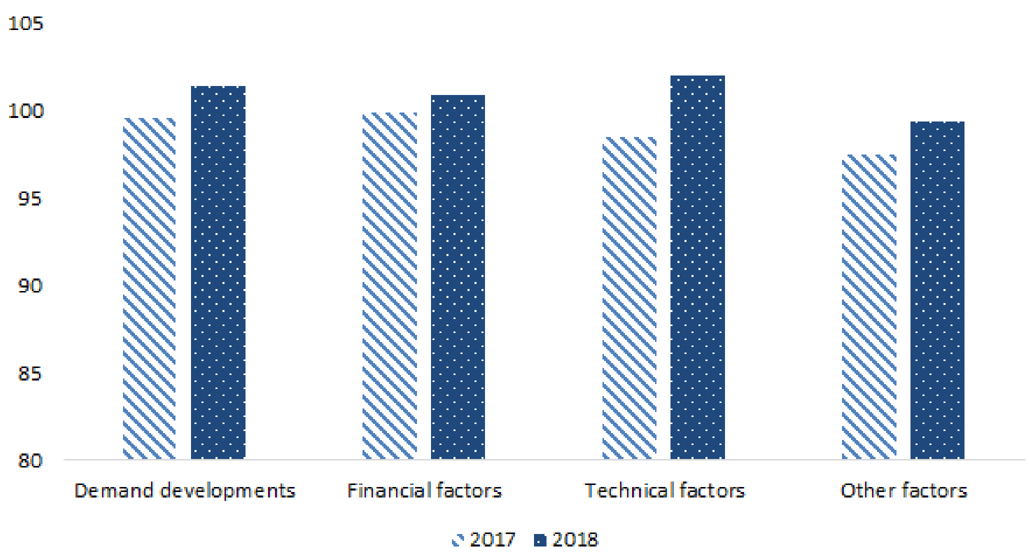
Figure 10 – Investment in manufacturing and assessment of accessibility of credit
(percentage changes and percentage balance)



Source: based on Istat data.

The more favourable developments in capital accumulation are confirmed by Istat surveys, which show the sixth consecutive monthly improvement in the balance of domestic orders for capital goods. Equally positive signs are provided by the Bank of Italy's Survey on Inflation and Growth Expectations in December, which points to an expansion in investment plans in manufacturing and services in the early months of 2018. The most recent half-yearly Istat survey of firms' investment plans also shows a gradual recovery in confidence among firms that plan to invest this year (Figure 11).

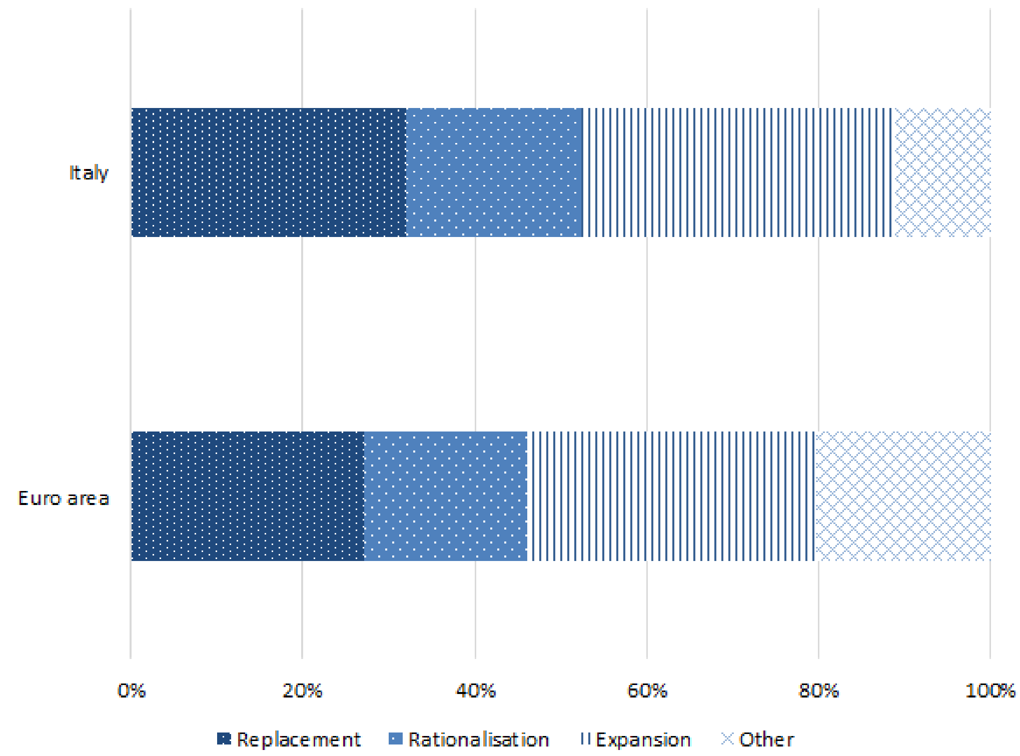
Figure 11 – Motivation for investments according to manufacturing firms
(2000-2017 average = 100)



Source: PBO based on Istat data.

For 2018, the same survey reveals a broad improvement in firms' assessment of developments in demand and the availability of financing and profit expectations. Evaluations of technical factors, such as the availability of labour and the ability of workers to adapt to new technologies are also higher than the long-term average (set at 100). Assessments of other aspects (such as, for example, fiscal policy issues) were also revised upwards slightly to a level close to the long-term average. One change compared with the previous survey was the fact that the more favourable investment conditions have been driving not only initiatives to increase efficiency but also projects to expand the production base. This bring Italy more in line with the situation found in similar surveys in other European countries than in the recent past. One persistent difference with the euro-area average remains Italy's smaller share of investment in environmental protection, waste treatment and workplace safety (included in "Other" in Figure 12).

Figure 12 – Planned purpose of investment in manufacturing in 2018
(percentage shares)



Source: based on Istat data.

Exports and imports accelerate

The expansion in the volume of exports of goods and services continued in the third quarter (+1.6 per cent compared with the average for April-June; +5.3 per cent over the same period of the previous year), driven by favourable developments in foreign markets. This performance, which represents a sharp acceleration from the near stagnation that marked the spring months, was mainly fuelled by merchandise exports (+1.8 per cent), which outpaced exports of services (+0.4 per cent).

The information available for the final part of 2017, which covers October and November, shows broadly positive signs for merchandise exports in both value and volume terms (obtained by deflating the value figure with producer prices on foreign markets), which posted increases of 2.5 per cent and about 2 per cent, respectively, compared with the average for the third quarter. Istat's survey of manufacturing firms in December shows an improvement in assessments of orders and turnover on international markets, pointing to a continuation of the good performance of exports in the fourth quarter of 2017 as well.

The good performance of exports was accompanied by growth in imports, albeit at a slower pace (+1.2 per cent on the previous period), driven by the recovery in domestic demand (especially investment) and that in exports themselves. Economic indicators also signal strong growth in imports in the fourth quarter, especially in purchases of intermediate goods and energy.

The latest economic indicators

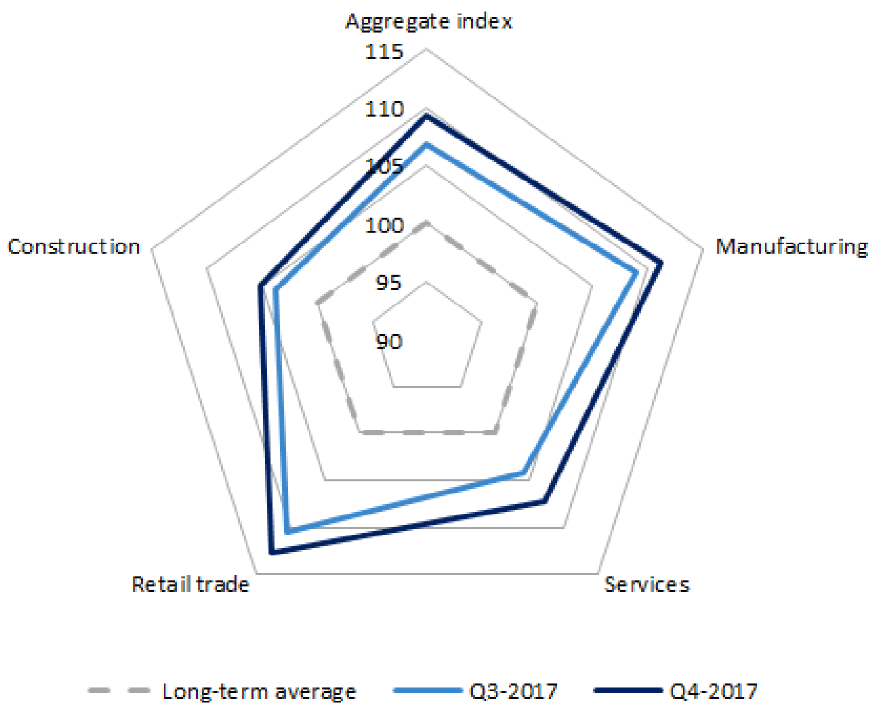
The most recent economic indicators for the major sectors show generally robust growth in output, although it is slightly less buoyant than in previous quarters. The strong performance of industrial production in the three summer months was followed by a period of uncertainty in October and November, in which developments in the various segments differed considerably, with increases in the output of energy goods contrasting with decreases in the manufacturing segments (consumer, capital and intermediate goods). Nevertheless, qualitative indicators suggest that economic activity will continue to grow in the short term: in the fourth quarter of 2017, the PMI for the manufacturing sector rose by about two points compared with the average for July-September, while the climate of confidence of industrial firms measured by Istat in December remained close to its pre-crisis levels. According to PBO estimates, industrial activity should have expanded in the fourth quarter as well, although the pace of growth was slower than the average for the third quarter.

Output in the construction industry declined slightly (by an average of -0.2 per cent in October-November compared with the third quarter of 2017), remaining at the historically low levels that characterised 2015-2016. Nevertheless, confidence - despite declining in December compared with the previous month - continues to follow a positive trend. Favourable signs also came from the survey conducted by the Real Estate Market Observatory, which showed a continuation of the growth in the number of sales that began in 2014. The housing market survey conducted in September-October by the Revenue Agency, the Bank of Italy and Tecnoborsa indicates an improvement in real estate professionals' assessment of sales prices (increasing) and discounts on asking prices (declining). The weakness of housing prices continued in the third quarter (when they declined by 0.5 per cent on the previous quarter), reflecting the persistent decline in the prices of existing housing, which more than offset the acceleration in the prices of new homes.

The recovery that began in the spring of 2014 in the services sector slowed in the third quarter. The index of turnover in value terms rose by 0.1 per cent over the previous quarter (+2.6 per cent year on year), reaching the level seen at the end of 2011. Looking at services by segment of activity, stronger growth was posted by transportation and storage services, and by professional, scientific and technical activities. Conversely, travel agencies and business services, information and communication services and accommodation and food services stagnated or contracted moderately. In the short term, qualitative indicators continue to provide broadly positive signals, with the level of confidence in the market services sector rising sharply in October-December compared with the average for the third quarter. An improvement in the climate of confidence is also found in retail trade, which in December had nearly recouped the decline posted in the previous month, returning to the growth path begun in the middle of last year.

For all sectors, the average aggregate index of business confidence for the fourth quarter, obtained as a weighted average of sectoral indices, was higher than the average for the third quarter as well as the long-term average. More specifically, there was widespread improvement in confidence in productive sectors, especially in market services (Figure 13).

Figure 13 – Confidence in productive sectors (1)
(index; average January 1998 - December 2017=100)



Source: based on European Commission and Istat data.
(1) The aggregate confidence indicator is constructed by applying the weights used by Istat to produce the Istat Economic Sentiment Indicator (IESI) to the time series (standardised) of sectoral confidence indicators of the European Commission.

Short-term forecasts

Overall, recent developments suggest that economic growth will continue between the end of 2017 and the early months of this year, albeit at a somewhat slower pace than in previous quarters. More specifically, on the basis of the forecasts produced with the PBO's short-term models, it is estimated that GDP may have risen by about 0.3 per cent quarter-on-quarter in the fourth quarter of 2017 (this value falls within an error band of 90 per cent with a maximum limit of 0.4 per cent and a minimum of 0.2 per cent). This was driven on the supply side by the strong performance of services, offset by a slowdown in manufacturing and the persistent weakness in construction. On the demand side, factors included the continuation of the recovery in investment and the resilience of consumer spending. The impulse from exports remained significant, but was offset by developments in imports. The forecasts for the first quarter of 2018, affected by greater uncertainty, indicate a moderation of the recovery, with quarter-on-quarter growth of about 0.2 per cent within an error band with a maximum limit of 0.35 per cent and a minimum of 0.05 per cent), essentially due to a possible slowdown in exports as a result of the appreciation of the euro. The estimate for the fourth quarter would produce average GDP growth for 2017 of 1.5 per cent adjusted for the number of working days, corresponding to an unadjusted expansion of 1.4 per cent. This performance is expected to be repeated this year, followed by a deceleration in 2019 (the PBO's medium-term forecasts are presented in the Box *2017-2019 macroeconomic forecasts*).

Labour market improves, with gradual decline in unemployment

In the labour market, developments in employment - measured in terms of full-time equivalent labour units – remained positive on average in the third quarter, both compared with the previous quarter (+0.5 per cent) and the same period of 2016 (+1.3 per cent). This performance was confirmed by the findings of the Istat Labour Force Survey, which underscore the driving role played by payroll employment (+0.6 per cent on the previous period), compared with a contraction in self-employment (-0.4 per cent). On the demand side, the information drawn from mandatory employer reports of the Ministry of Labour shows an overall increase in positions of 75,000 compared with April-June, caused by an increase in fixed-term employment (+81,000) offset in part by a decrease (-6,000) in open-ended jobs. The monthly labour market monitoring conducted by INPS finds an increase in the number of temp and on-call workers, partly reflecting the elimination of the casual supplementary employment category.

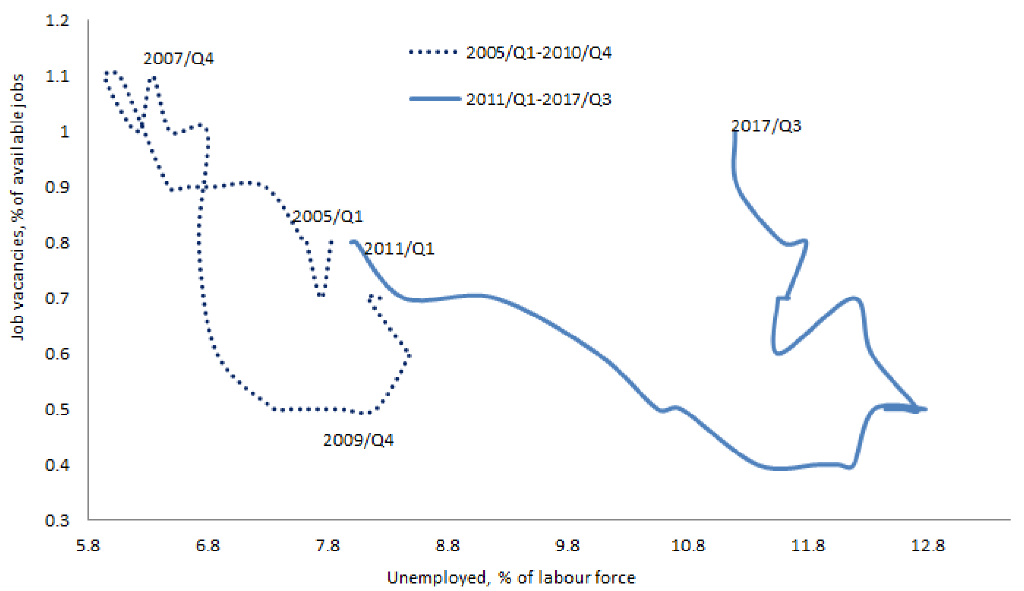
The most recent information on the labour market show a further increase in the number of persons in employment compared with the previous month (+65,000 in November compared with October). On average in October-November, the number of persons in employment increased by 0.3 per cent on the third quarter. This rise was again sustained by the growth in fixed-term employment, compared with a decline in permanent hiring and no change in self-employment. At the same time, the number of job seekers contracted (-1.5 per cent compared with the July-September average). The increase in the labour supply, boosted by the strong economic conditions, helped slow the decline in the unemployment rate, which was virtually unchanged (an average of 11.1 per cent in October-November) on the third quarter.

The gradualness of the improvement in the unemployment rate in the current recovery stands out in a comparison with the job vacancy rate (which measures the proportion of jobs for which firms are actively seeking candidates). These two variables are linked by an inverse relationship (the Beveridge curve) over the course of the business cycle: during a weakening of economic activity, firms' demand for labour diminishes and, with it, the share of vacant jobs, accompanied by an increase in the unemployment rate; the opposite occurs as the economy strengthens.

These developments are visible in the phases of the cycle that have characterised the Italian economy over the last decade (Figure 14): the pre-crisis expansion of 2005-2007, the recession of 2008-2009, the second recession of 2011-2013 (following a temporary recovery) and the more recent recovery that began in 2014. Nevertheless, the negative relationship between vacancies and unemployment shifted outwards during the 2011-2013 recession (moving away from the origin of the axes), a development that appears even more accentuated in the current recovery. This shift may indicate a structural deterioration, due to the intensification in recent years of the mismatch between qualifications and the skills sought by firms and those offered by workers: according to the Beveridge curve that characterised the last decade, a job vacancy rate of 1 per cent (such as that registered in the third quarter of 2017) should be associated with an unemployment rate of about three-fifths the observed rate (an average of 11.2 per cent in the third quarter of 2017).

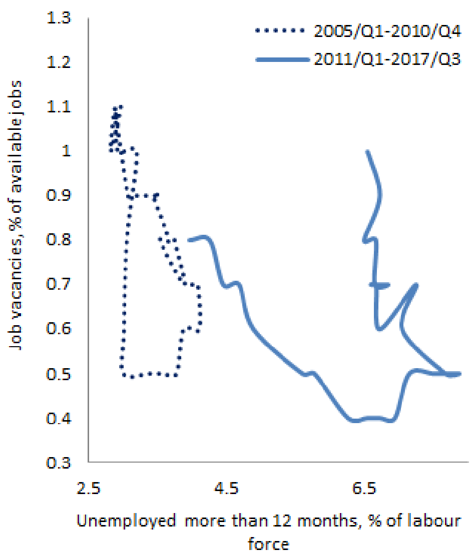
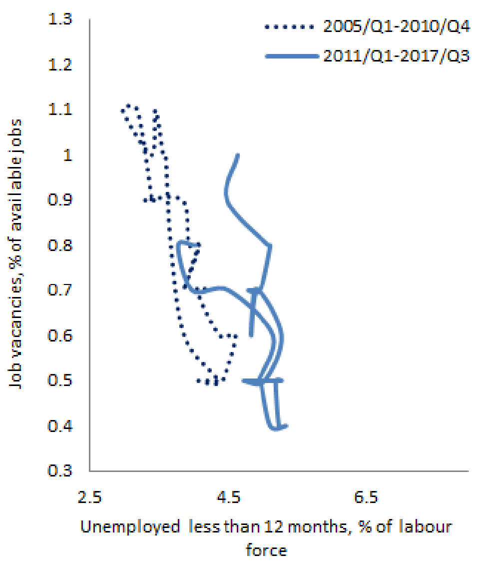
An analysis of periods of unemployment by duration reveals that the deterioration differs among the various categories of job seekers, but essentially affects individuals who have been unemployed for more than a year (Figure 15a and 15b). The mismatch in the labour market was therefore accentuated in the last recession by the increase in the number of long-term unemployed (which rose to about 60 per cent of job seekers, up from 45 per cent prior to the crisis). These unemployed persons, who have not had a job for quite a long time, may be perceived as a poorer match for the skills and qualifications that firms need, even during a recovery in the demand for labour.

Figure 14 – Unemployment rate and job vacancies
(percentages)



Source: based on Istat data.

Figure 15 – Unemployment rate and job vacancies
(percentages)

a) Long term	*b) Short term*
	

Source: based on Istat data.

Inflation remains modest

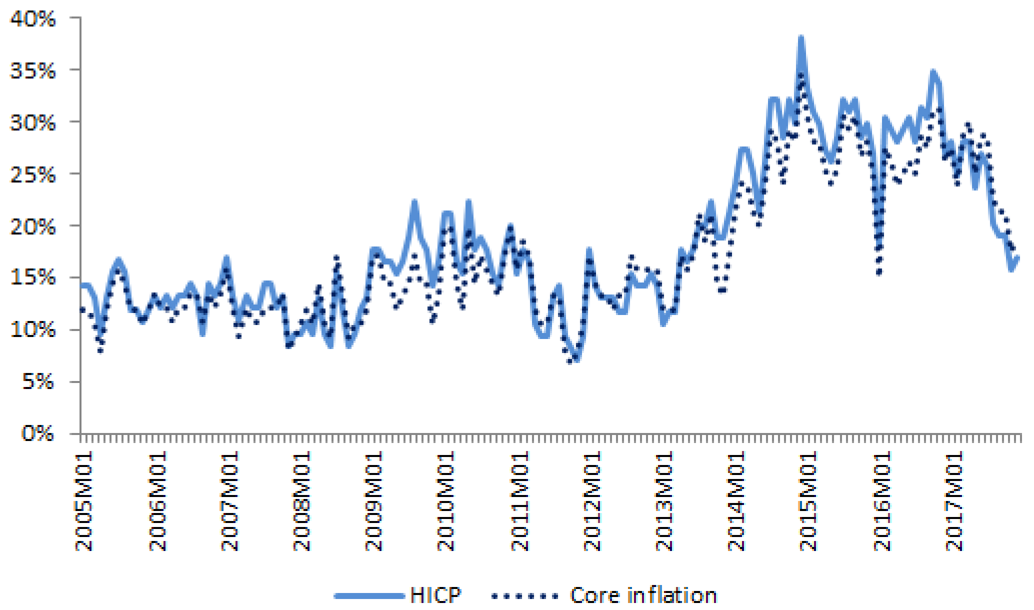
Despite the strengthening of the recovery, inflation remained modest in the closing months of 2017. The rise in oil prices at the start of 2018 should help lift inflation in the early months of the year, attenuating the adverse comparison with the more lively developments in prices in the same period of 2017. Wage pressures remain weak, although they show some signs of a revival thanks in part to the fact that contract renewals signed towards the end of 2017 did not contain indexing mechanisms that might slow the pace of wage growth.

In December, consumer price inflation (measured with the national index for the entire population) increased by 0.4 per cent compared with the previous month and 0.9 per cent compared with the year-earlier period (equal to the increase registered the previous month). Core inflation, which excludes the prices of energy products and unprocessed food and best reflects domestic price pressures, confirmed the weakness seen in November, at 0.4 per cent. Inflation in goods prices slowed compared with November (1.1 per cent, down from 1.3 per cent), reflecting the deceleration in the prices of unprocessed food products (+2.4 per cent, from +3.2 per cent the previous month) and unregulated energy products (+4.4 per cent, from +5 per cent in November). By contrast, the prices of services accelerated (+0.6 per cent from 0.5 per cent year-on-year), driven by increases in the transportation sector (+2.8 per cent, from +2.2 per cent in November).

In December, the share of goods and services whose prices are still decreasing continued to decline. The proportion of items in the harmonised consumer price index whose prices are falling was 17 per cent, down 10 points in 6 months but still well above the pre-crisis level of about 10 per cent (Figure 16). Compared with December 2016, the percentage of items experiencing low inflation (year-on-year increases of less than 0.5 and 1 per cent) also decreased significantly.

Overall, considering developments in December, in 2017 consumer prices (national index for the entire population) increased by an average of 1.2 per cent (+1.3 per cent for the harmonised index), after falling slightly in 2016. Core inflation amounted to 0.7 per cent (+0.8 per cent for the harmonised index), two-tenths of a point greater than the previous year. According to Istat, the effects of price increases, especially those for unprocessed food and energy, were primarily felt by households with the lowest monthly expenditure,[2] with an annual average differential with households with higher spending of about a tenth of a point, a figure that rises to four-tenths in the last quarter.

Figure 16 – Proportion of goods and services in the HICP experiencing deflation
(percentage shares)



Source: based on Istat data.

[2] Istat groups households into quintiles of equivalent expenditure to take account of household size.

Inflation in the upstream stages of the inflationary process, the producer prices of industrial goods began to revive toward the end of 2017 (+2.5 per cent year-on-year in November), after slowing in the summer, thanks primarily to the contribution of goods sold on the domestic market (+2.8 per cent), mainly reflecting developments in the prices of intermediate goods. The rise in producer prices in the services sector continued, increasing by an average of 1 per cent in the third quarter of 2017, thanks to widespread increases in many segments of economic activity (maritime and air transport, information and communication services, professional, scientific and technical activities).

Increases in energy prices continued to drive the import prices of industrial products, which rose by 0.9 per cent on the previous period in November (+0.1 per cent net of energy products) for the fourth month in a row. The rise in import prices gained pace in year-on-year terms as well, reaching 3.1 per cent in November (+2.1 in October), although this was below the levels registered at the start of 2017 (close to 5 per cent).

The Istat survey of price expectations in December showed a slight downturn in household expectations compared with last autumn, with an increase in the proportion of respondents expecting prices to fall (2.7 per cent, from 2.3 per cent the previous month) or hold steady (51.9 per cent, from 47.8 per cent) and a corresponding decrease in those expecting prices to accelerate (13 per cent, from 15.5 per cent). The balance went from -1.5 in November to -14.7 in December, reflecting the fact that the calculation method assigns a double weight to the extremes. Nevertheless, the percentage of undecided respondents also increased, rising to over 8 per cent at the end of the year. By contrast, firms are expecting an increase in prices. The share of those expecting list prices to rise in the coming 12 months increased (13.5 per cent, from 10.7 per cent), with a slight rise in the proportion of those expecting a decrease (4.3 per cent, from 3.8 per cent). This development spread to all categories of goods (consumer, capital and intermediate), with about 3 per cent of respondents shifting their views from "stationary prices" to "rising prices".

Box – 2017-2019 macroeconomic forecasts

Beginning with this Report on recent economic developments, the PBO presents its three-year macroeconomic forecasts for Italy.[3]

Forecasting assumptions. The forecast for the 2017-2019 period (Table R1), based on information available as at 23 January, is based on a set of assumptions concerning international economic variables and the public finance. For the international scenario, we assume: 1) the general continuation of the global recovery, with world trade in goods in services increasing by 4.6 per cent in 2018 (after an estimated +4.7 per cent for 2017) and 4.4 per cent in 2019, in line with the profile forecast by the IMF in its update of 22 January; 2) the continuation of broadly expansionary monetary conditions, in line with market expectations, accompanied by a short-term interest rate in the euro area of -0.3 per cent in 2018 (as in 2017) and close to zero in 2019; 3) an appreciation of the euro over the course of the forecasting period in line with forward market prices (average of the ten days preceding the cut-off date for the forecasts), with an average dollar/euro exchange rate of 1.23 in 2018 (1.13 in 2017) and 1.26 in 2019; 3) an increase in oil prices, based on futures prices observed in the same period for forward exchange rates, to an average of $66.9 a barrel in 2018 (from $54 in 2017), before a decrease to $63 in 2019. The public finance scenario incorporates the measures contained in the 2018-2019 budget package. This means that in 2018 the VAT safeguard clause is fully deactivated, while in 2019 it is only partly deactivated, with a consequent increase in indirect taxes in that year.

Growth. On the basis of these assumptions and recent economic developments, GDP is estimated to have increased by 1.4 per cent on an unadjusted basis in 2017 (see the text of the Report for more information). After moderating at the start of 2018, the recovery is expected to gain pace in the following quarters, posting an increase of 1.4 per cent for the year as a whole. In 2019, GDP growth is forecast to slow to 1.2 per cent. Compared with the recent growth projections developed by other institutions (we consider the projections issued by leading forecasters in December-January, Table R2), the PBO forecast (taking due account of calendar adjustments by the various forecasters) appears to be in line with most projections in 2017 and slightly lower in 2018 (with the exception of the IMF forecast for that year, which is equal to the PBO estimate). For 2019, the PBO forecast for GDP growth is in line with those of the Bank of Italy, CER and Confindustria, slightly lower than that issued by REF and higher than those of the IMF and Prometeia. In making such comparisons, it is necessary to bear in mind that fact that they reflect the different assumptions of the forecasters, especially as regards international variables and developments in the public finances.

Components of expenditure. In the PBO scenario, Italian economic growth is essentially driven by final domestic demand, which contributes 1.5 percentage points of growth in 2017 and 2018 and 1.1 points in 2019. The contribution of net foreign demand, equal to zero in 2017, turns negative by one-tenth of a point in 2018, before returning to zero in 2019. The contribution of stock-building to GDP growth, which is slightly negative in 2017, is assumed to be neutral in 2018 and 2019. With regard to the main components of final demand, investment grows rapidly overall in 2017-2019, thanks to the strengthening of spending on machinery, plant and transport equipment. Capital accumulation is especially driven by the good outlook for demand, the continuation of favourable conditions on financial markets and the tax incentives envisaged in the Budget Act. Household consumption is expected to continue growing, benefitting from the improvement in financial conditions and reflecting, especially in 2018, the increase in disposable income, with the latter a reflection of the continuation of the improvement in the labour market. In 2019, consumption would be affected by the erosion of household purchasing power caused by the increase in indirect taxes, but would decelerate less than disposable income. With regard to foreign demand, after the strong performance posted in 2017, exports are expected to slow in

[3] The Parliamentary Budget Office develops its projections using a version of the annual MeMo-it model of Istat that incorporates modifications made by PBO to adapt it to its specific requirements. That model and the other forecasting tools used by the PBO are discussed in the technical report *"Gli strumenti di previsione macroeconomica dell'UPB"*.

2018 and 2019, mainly due to the impact of the appreciation of the euro, which would cause a loss of price competitiveness of more than 2 per cent over the course of 2018 and 2019. After the acceleration posted in 2017, imports grow more slowly this year and in 2019, albeit still reflecting the stimulus imparted by growth in investment.

Table R1 – Forecasts for the Italian economy
(percentage changes and shares, unless otherwise indicated)

	2016	2017	2018	2019
INTERNATIONAL EXOGENOUS VARIABLES				
International trade	2.2	4.7	4.6	4.4
Price of oil (Brent, dollars per barrel)	43.7	53.9	66.9	63.1
Dollar/euro exchange rate	1.107	1.129	1.230	1.260
ITALIAN SCENARIO				
GDP in volume terms	0.9	1.4	1.4	1.2
Imports of goods and services	3.1	6.1	4.5	3.8
Final national consumption	1.3	1.2	0.9	0.8
- consumption of households and NPISH	1.5	1.4	1.2	0.9
- general government expenditure	0.5	0.8	0.1	0.2
Investment	2.8	3.1	4.2	2.9
Exports of goods and services	2.4	5.5	3.7	3.5
CONTRIBUTIONS TO GDP GROWTH				
Net exports	-0.1	0.0	-0.1	0.0
Inventories	-0.4	-0.1	0.0	0.0
National demand net of inventories	1.5	1.5	1.5	1.1
PRICES AND NOMINAL GROWTH				
Terms of trade (export prices - import prices)	2.4	-1.0	0.4	1.1
Consumption deflator	0.0	1.1	1.2	1.7
GDP deflator	0.8	0.5	1.4	1.9
Nominal GDP	1.7	1.9	2.7	3.1
LABOUR MARKET				
Unit labour costs	0.5	0.5	1.2	1.4
Employment (FTE)	1.4	1.3	1.2	0.9
Unemployment rate	11.7	11.3	11.0	10.6

Table R2 – Recent growth forecasts for the Italian economy
(percentage change in GDP in volume terms)

	2017	2018	2019
PBO (26 January), unadjusted	1.4	1.4	1.2
PBO (26 January), adjusted for calendar effects (1)	1.5	1.3	1.2
REF (25 January) , adjusted for calendar effects (1)	1.5	1.6	1.3
IMF (22 January), unadjusted	1.6	1.4	1.1
Bank of Italy (19 January), adjusted for calendar effects (1)	1.5	1.4	1.2
Bank of Italy (19 January), unadjusted	1.4	1.5	1.2
Prometeia (17 December), adjusted for calendar effects (1)	1.6	1.5	0.9
CER (15 December), unadjusted	1.5	1.5	1.2
Confindustria (13 December), unadjusted	1.5	1.5	1.2
Memo item			
MEF (October), unadjusted	1.5	1.5	1.5

(1) 2017 has two fewer working days than 2016, 2018 has three more working days than 2017, and 2019 has the same number of working days as 2018.

Labour market. Against the general background of recovery, employment (measured in standard labour units) is forecast to expand by 1.3 per cent in 2017 and 1.2 per cent in 2018, before decelerating to 0.9 per cent in 2019 in reflection of slower economic growth. Unemployment will decline gradually, reflecting the continuation of the expansion in the supply of labour and the slow decline in the pool of long-term unemployed. The unemployment rate is projected to fall from 11.3 per cent in 2017 to 10.6 per cent in 2019.

Inflation and nominal growth. Inflation, as measured by changes in the consumption deflator, is forecast to rise only slightly in 2018 (an average of 1.2 per cent, compared with an estimated 1.1 per cent in 2017) before strengthening in 2019 (1.7 per cent), driven by the gradual increase in wage growth and the increase in indirect taxes. Next year, domestic inflationary pressures are expected to be partly offset by the deflationary impulse of foreign factors (a decline in oil prices and a further appreciation of the euro). Against the background of an improvement in the terms of trade fostered by the strengthening of the euro, the GDP deflator is expected to outpace these developments, accelerating from an estimated 0.5 per cent in 2017 to 1.4 per cent this year and 1.9 per cent in 2019. Given the change in real GDP, nominal GDP growth would be at 1.9 per cent in 2017, 2.7 per cent in 2018 and 3.1 per cent in 2019.

Risks for the forecast. The risk factors underlying the forecasting scenario are mainly associated with developments in international variables. The global scenario used as the basis for the macroeconomic projections assumes the containment of geo-political tensions, the gradual normalisation of monetary policies in the main economies, the absence of abrupt corrections in the financial markets and the preservation of the international openness of economic systems. Significant episodes of instability or disruptions on these fronts could have an impact on world growth, raw materials prices and equity markets, with adverse effects on exports and domestic spending decisions in Italy. These international uncertainties are accompanied by the specifically Italian macroeconomic issue concerning the economic policy choices of the new Government.