Summary *

After slowing at the end of 2015 (partly reflecting statistical factors), Italian economic activity gathered pace in early 2016. According to the PBO, GDP may have jumped by 0.4 per cent in the first quarter, before decelerating (towards 0.2 per cent) in the second. On the basis of these projections, in order to achieve an average growth rate of 1.2 per cent in 2016, as assumed in the 2016 EFD, GDP would have to grow at a rate of 0.5 per cent in the third and fourth quarters of the year.

With foreign demand attenuated by the weakness of the emerging markets, consumption has been the main driver of the recovery, thanks in part to the gradual rise in household disposable income. By contrast, investment expenditure does not fully reflect the stimulus from the reduction in interest rates and the fall in energy costs. The slow recovery in capital accumulation registered in recent quarters primarily reflects an increase in expenditure to replace obsolete capital goods. Direct investment to expand capacity remains weak, with a detrimental impact on the stock of capital.

On a sectoral basis, the recovery in production at the start of 2016 reflects an acceleration in industry, accompanied by moderately positive developments in services and the consolidation of favourable signals in construction. Compared with early 2015, the recovery in industry appears more widespread (about 70 per cent of sectors are growing) but not very strong. After a jump in hiring towards the end of 2015, employment growth slowed in early 2016 in association with the reduction in fiscal contribution relief. Employment is still expected to expand moderately over the remainder of the year. Inflation has returned to negative territory under the deflationary impulse of falling oil prices. However, core inflation also remains very low owing to weak domestic inflationary pressures on costs and prices.

Economic conditions in Italy remain primarily exposed to external risks. The signs of a slowdown in the world economy appear to have stabilised compared with the fears that emerged at the start of the year, but growth forecasts for 2016 have again been revised downwards by forecasters. The factors of financial and geo-political instability, which are concentrated in the emerging areas, could slow international growth. If global economic conditions should deteriorate, the economic policy tools available to the advanced countries currently appear too weak to implement appropriate counter-cyclical action.

The international environment

Prepared by the Macroeconomic Analysis Department. Information updated to 27 April 2016.

Conditions more stable but fragility persists

The signs of a slowdown in the global economy stabilized in the most recent period. The partial recovery of oil prices attenuated but did not eliminate international deflationary pressures. Among the emerging economies, the slowdown in China appears to be continuing as expected, easing the fears of a sharper deceleration that had emerged at the start of the year. Brazil and Russia remain in recession, while India is expanding rapidly.

Among the advanced economies, growth in the United States moderated between the end of 2015 and the early months of this year. In April, that economy marked its eighty-second consecutive month of expansion, according to NBER figures. The previous expansion, which culminated in November 2007, lasted eighty-five months. The cyclical recovery in the 1990s was considerably longer, at 120 months. The resilience of consumption and the improvement in the labour market point to a continuation of growth during the year. In the euro area, the recovery is proceeding at a moderate pace, offsetting the weakness of foreign demand with more robust growth in internal demand. Leading indicators have presaged a slowdown in recent months. In March, the European Central Bank intensified the monetary stimulus in order to revive inflation expectations and support growth.

Although conditions have stabilised, the global economic environment is still marked by fragility. Persistent financial instability and geo-political strains could cause world growth to slow further. In April the International Monetary Fund (IMF) again lowered its forecast for world growth in 2016, returning it to the modest level registered the previous year (3.2 per cent); downside risks to the outlook predominate.

One source of concern regards the ability of the advanced countries' economic policies to respond to any deterioration in international economic conditions. As part of the effort to counter low inflation, interest rates are already close to zero everywhere, a highly unusual circumstance during a recovery. On the other hand, fiscal policies, which should be deployed to sustain the stimulus when monetary policy loses effect, are constrained by the low degree of coordination among the main countries, especially in Europe.

World trade expanding at a moderate pace

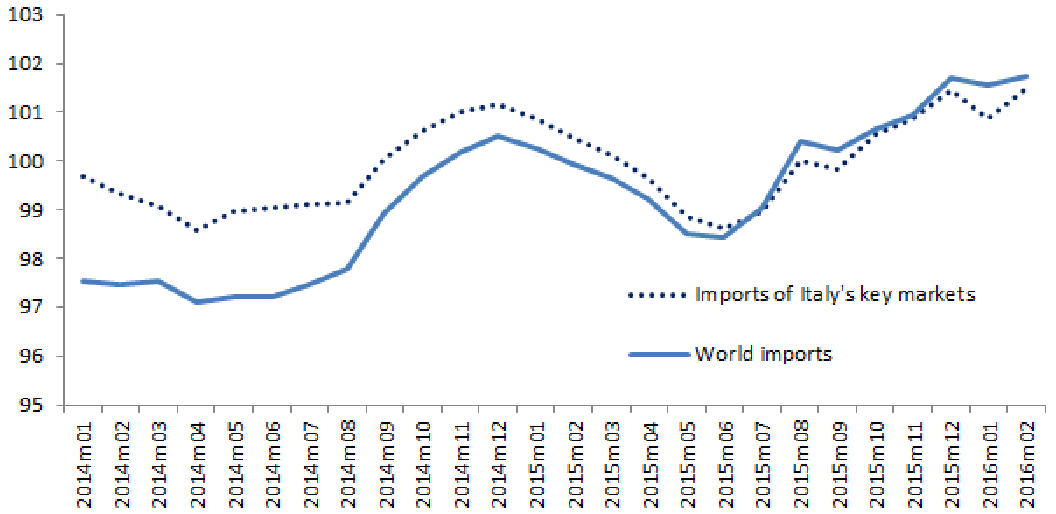
After contracting in the first half of last year, world trade began the recover last summer (Figure 1). According to preliminary estimates for February published by the Central Planning Bureau (CPB), world imports increased by 5.5 per cent from the low registered last June, while Italy's main export markets grew slightly faster (6 per cent). Looking forward, trade growth is expected to continue at a moderate pace, reflecting the slow rate of expansion in global economic activity. In its April forecast, the IMF projects moderate growth in world demand in 2016 and 2017 (3.1 and 3.8 per cent, with a downward revision of 0.3 percentage points for both years compared with the January forecast). Similar projections are used in the 2016 Economic and Financial Document for 2016-2017 (3 and 3.8 per cent).

Oil prices rising from their lows at the start of the year; the euro is appreciating

Expectations of an agreement among the leading oil producers and the start of a decline in US output helped foster a partial recovery in oil prices from the lows posted in January/February (Figure 2). In April, the price of Brent averaged more than $40 a barrel, a rise of about 35 per cent from the start of 2016 (-30 per cent on a year earlier). Differences among the largest producers nevertheless make it unlikely that any accord will endure, as the failure of the recent Doha talks underscored. The market remains conditioned by excess supply, which is likely to decline only slowly in the light of forecasts for moderate growth in the world economy. In line with this scenario, the outlook of forward markets does not incorporate any continuation of the rebound registered at the start of 2016 but does reflect gradually rising prices in the coming years. The assumptions adopted in the 2016 EFD ($39 a barrel in 2016, $46 in 2017, $48 in 2018 and about $50 in 2019) are broadly in line with these expectations.

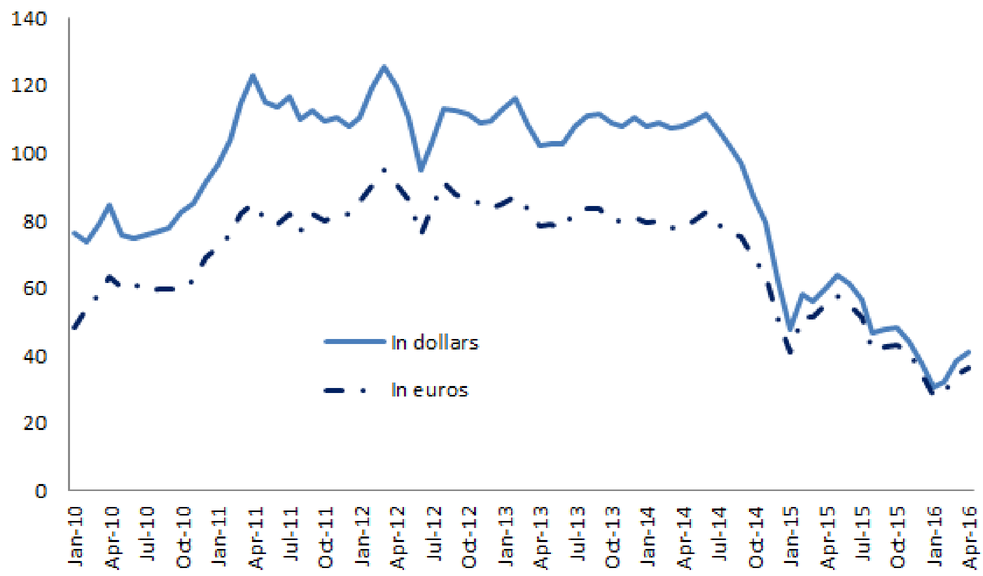
The euro has tended to appreciate against the dollar in conjunction with the rise in oil prices, thereby containing the increase in oil prices in euro terms. The strengthening of the single currency has also been impacted by the change in the stance of US monetary policy, with a shift towards an increase in interest rates, albeit a more gradual rise than indicated in the initial intentions of the Federal Reserve. The appreciation of the euro is even greater if we consider a broader basket of currencies, reflecting the weakness of the currencies of the emerging economies (Figure 3). The strengthening of the European monetary stimulus decided in March by the ECB did not reverse this trend. The expectations reflected in the forward market point to a continuation of the gradual appreciation of the euro against the dollar by about 2 per cent a year. This trend appears to conflict with the technical assumption of constant exchange rates adopted in formulating the 2016 EFD projections for 2016-2019.

Figure 1 – World imports and Italy's key markets
(2015=100: quarterly moving averages)



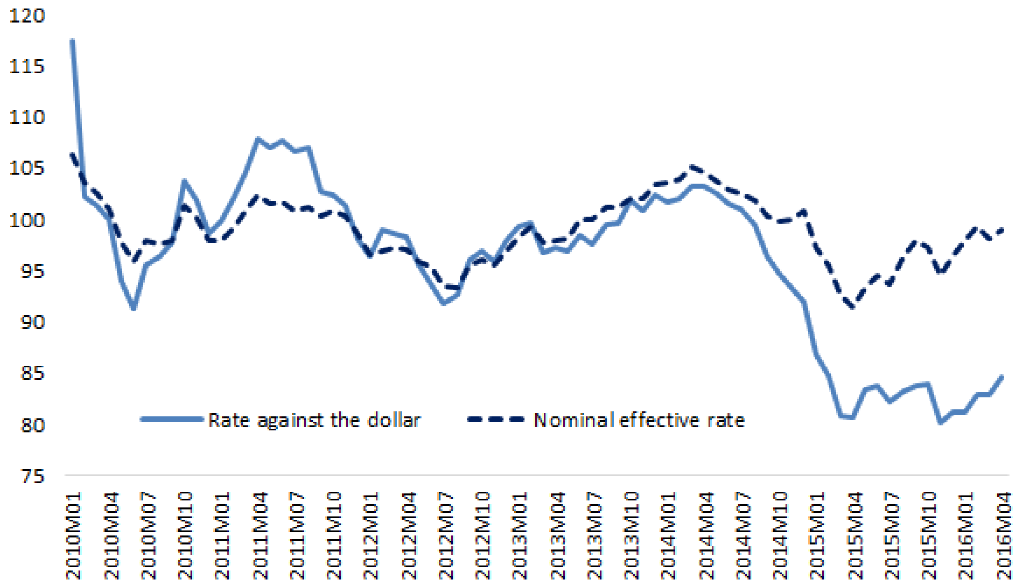
Source: based on Central Planning Bureau data.

Figure 2 – Oil prices
(Brent crude)



Source: based on Energy Information Administration and ECB data.

Figure 3 – The euro exchange rate



Source: European Central Bank

Italian economy

The recovery flags at the end of 2015, driven by consumption, while investment struggles

The pace of the Italian recovery subsided in the second half of 2015. In the last quarter of 2015, GDP expanded by 0.1 per cent (after increases of 0.4, 0.3 and 0.2 per cent in the first, second and third quarters respectively). GDP expanded by 0.6 per cent on average in 2015, adjusted for calendar effects. On an unadjusted basis, GDP rose by 0.8 per cent.

The deceleration at the end of 2015 reflected a slowdown in growth in inventories (with a negative contribution of 0.4 percentage points to GDP growth). By contrast, the contribution of final domestic demand to growth remained positive (at 0.4 points). The contribution of net foreign demand (exports less imports) was also slightly positive (0.1 per cent), thanks to the good performance of exports, which were buoyed by the growth of European markets.

Private consumption continued the recovery under way since the end of 2013 (in the fourth quarter of last year household consumption expenditure rose by 1.1 per cent year on year). The improvement in the labour market helped foster an increase in purchasing power (up 0.9 per cent in the fourth quarter of 2015 compared with a year earlier) and in household confidence (although this underwent a partial correction in the survey at the start of this year). The easing of credit conditions helped produce an increase in purchases of durable goods (especially motor vehicles). Regardless of quarterly fluctuations, developments in consumer spending are broadly tracking those in disposable income. The average propensity to save, which has risen from the very low levels reached in 2012 (when it sank to a low of 6.5 per cent), stabilized over the course of 2015 at just over 8 per cent. This remains below the level (of between 10 and 11 per cent) that characterised Italian households before the squeeze on saving that occurred between 2010 and 2013 (Figure 4).

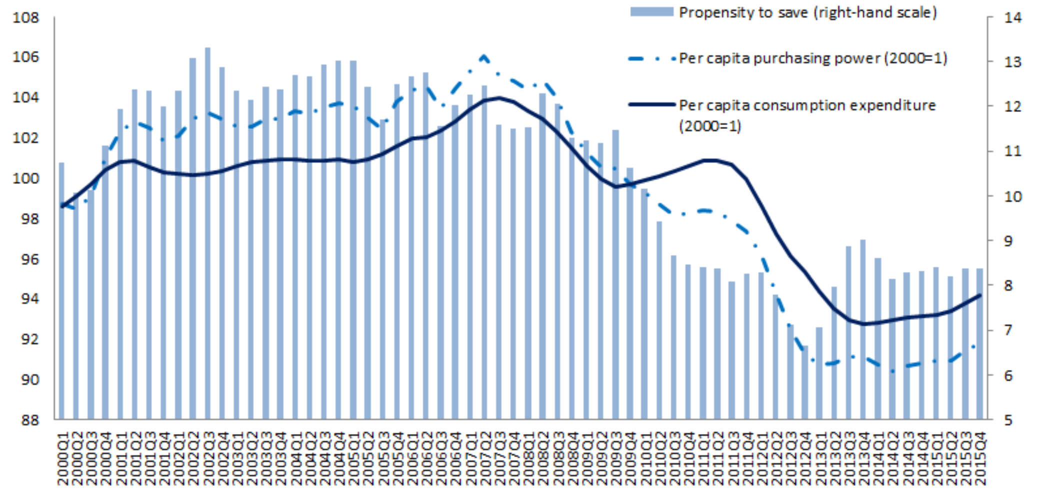
Developments in gross fixed investment were also relatively positive, accelerating in the final three months of 2015 (0.8 per cent, after posting growth of 0.2 per cent in the third quarter). The improvement reflected a continuation of the sharp increase in investment in transport equipment and signs of a recovery in construction. These factors more than offset the persistent weakness of investment in plant and machinery (-0.6 per cent).

Overall, investment expenditure does not fully reflect the exogenous stimuli present in the economy (in particular, the reduction in the cost of capital as a result of the expansionary stance of monetary policy and the reduction in energy costs). On average, firms are reporting an improvement in the terms of access to bank credit and a substantial easing of liquidity constraints in relation to operational requirements, but the impact in terms of the rebalancing of investment plans appears modest overall, especially if we consider the need to recoup the major loss of capital accumulation in the last seven years. The recent quarterly business survey of the Bank of Italy (March) shows only a slight increase compared with the previous survey in the (positive) difference between firms expecting an increase in nominal expenditure on investment in 2016 and those expecting a decrease.

The gradually more favourable evolution in investment observed in the final part of last year is reported gross of depreciation, i.e. the expenditure (which accounts for the large majority of total investment) of firms to replace technologically or economically obsolete capital goods. Net of depreciation, investment in expanding productive capacity has been negative since 2013 (Figure 5a). Estimates suggest that such investment remained negative during the weak recovery in gross expenditure registered in the final part of last year. Negative net investment implies a reduction in the stock of capital net of replacement expenditure. This phenomenon emerged during the recent recession and, as noted, is highly likely to have continued during the weak recovery in (gross) fixed capital accumulation in the final quarter of 2015.

Observing developments by branch of economic activity in recent years, the regression in the net capital stock was especially steep in construction, which essentially corrected the earlier increase registered during the robust expansion of the sector. The contraction has nevertheless been significant in industry and general government as well. Only private services have continued to display weak growth in the net capital stock (Figure 5b).

Figure 4 – Propensity to save, purchasing power and household consumption on a per capita basis (quarterly moving averages of seasonally adjusted monthly data)

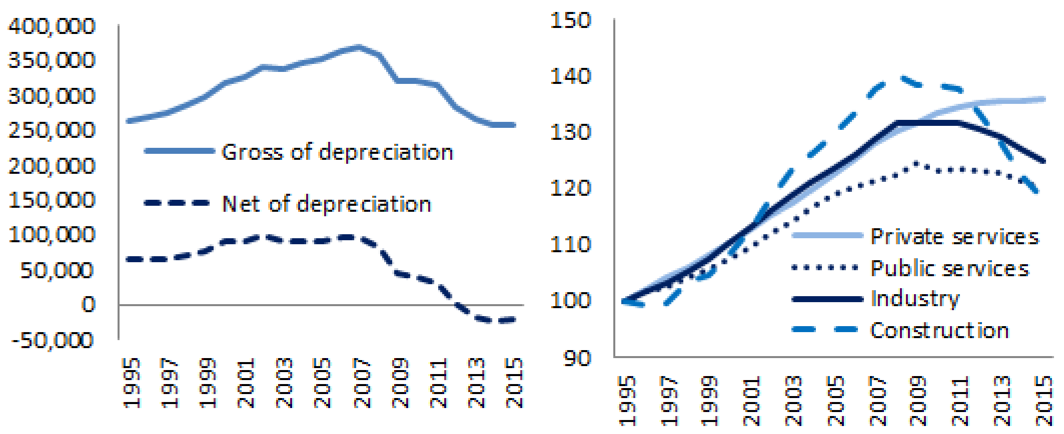


Source: based on Istat data.

Figure 5 – Gross and net total investment and the net stock of capital by branch of economic activity

a) – Total investment in volume terms (billions of euros: reference year 2010)

b) – Net stock of capital in volume terms (1995=100)



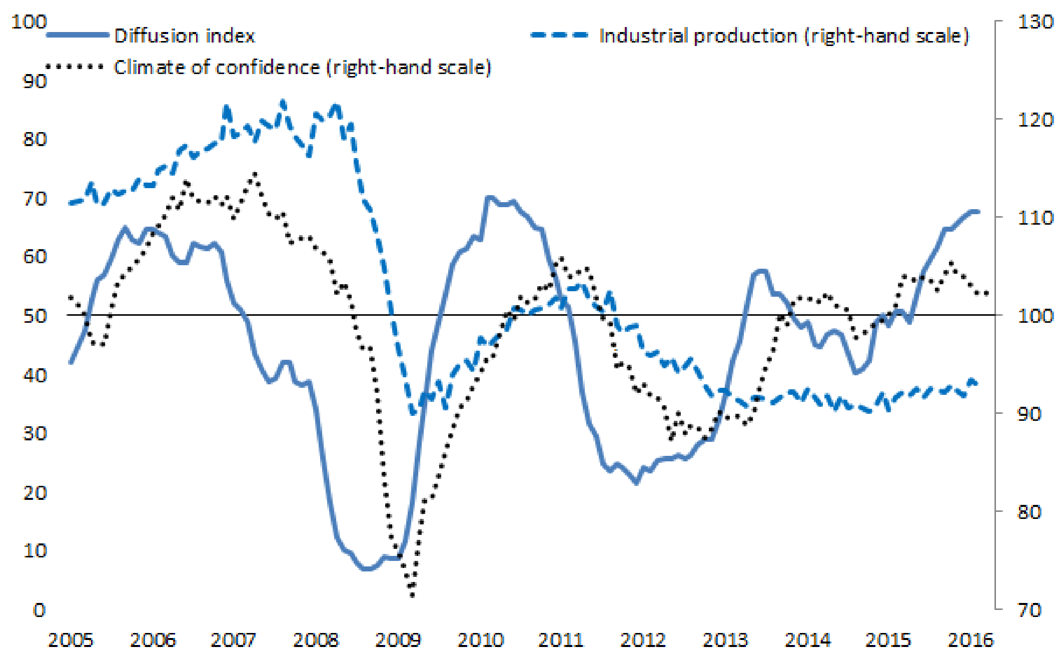
Source: based on Istat data.

Economy improves in early 2016 and the recovery in industry spreads

Following the slowdown registered in the last quarter of 2015, the information available on the first few months of 2016 points to a strengthening of economic activity. Industrial production posted a significant gain (an average of 0.9 per cent for the January-February period compared with the fourth quarter), offsetting the negative statistical effect of the holidays, which had likely depressed performance in the final part of 2015 (in the final quarter of 2015, industrial activity was stagnant). This relatively stronger performance was essentially confirmed by the figures for turnover and, above all, industrial orders, which reflected the driving force of the domestic market, compared with a weakening in foreign demand. In January-February, developments in world trade had adverse impact on exports, particularly in non-European markets.

With regard to the recovery in manufacturing, the improved figures at the start of 2016 and the retrospective revision of sectoral production indices with Istat's February release and implied the substantial increase in the sector diffusion of the recovery. The new data indicate that the percentage of manufacturing sectors that are expanding can be estimated at a level just under the peak reached in the recovery of 2010 (69 per cent; Figure 6).[1] The new information thus paints a picture of industrial activity that differs significantly from the situation at the end of 2015 with regard to the proportion of sectors involved in the cyclical expansion (which according to the information available in January was just over 50 per cent). By contrast, the intensity of industrial recovery remains very low, well below that registered during the 2010 recovery: in February, manufacturing was 2.7 per cent higher than the low posted in mid-2014, implying average monthly increases of 0.1 per cent. Over the same amount of time from its trough, the recovery in 2010 produced a gain of 11.5 per cent, with average monthly rises of 0.6 per cent.

Fiure 6 – Diffusion of the recovery in the manufacturing sector
(2010 = 100; seasonally adjusted)



Source: based on Istat data.

[1] The diffusion index is calculated by taking the share of manufacturing sectors (about 180 ATECO 4-digit sectors, excluding energy) in expansion, i.e. with a positive trend growth rate (obtained with a Kalman filter in an unobserved component model with trend, slope and seasonal components). Thus, a value of 50 indicates that 50 per cent of the sub-sectors are expanding. By construction, all the sub-sectors in the diffusion index have an equal weighting.

The climate of confidence among industrial firms as measured in the Istat sample survey deteriorated in early 2016, with a gradual recovery in the spring, but remained relatively high (at 102.7 in April, compared with an average of 102.5 in the first 3 months of the year). By contrast, the Purchasing Managers' Index (PMI) remained consistently slanted towards expansion.

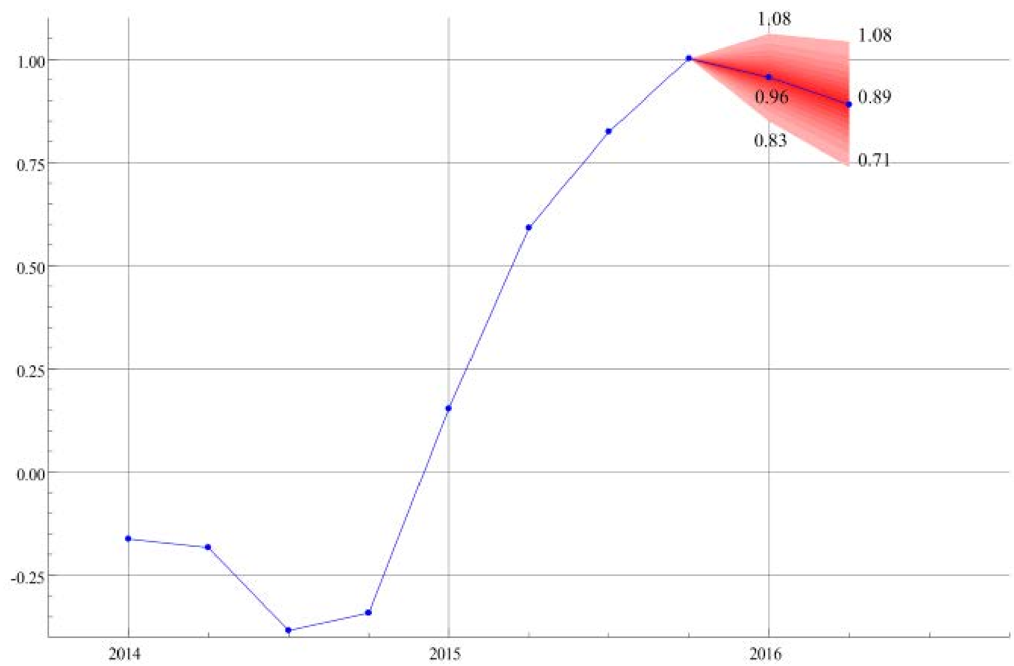
Signs of improvement in construction, while services are recovering gradually

As for the other sectors of production, construction is also showing signs of a gradual recovery. On average in the three months ending in February, the production index rose by about 0.7 per cent. In the real estate market, the decline in housing prices under way in 2015 came to a halt during the year. Although marked by considerable volatility, the confidence of sector operators has risen substantially (121.2 in April, compared with an average of 116.1 in 2015), with an improvement in the outlook for orders and construction plans as well as employment expectations. The recovery should also continue in services, albeit at a generally moderate pace, driven by the rise in consumption. The climate of confidence appears to have improved in market services in April. After halting in the fourth quarter of 2015, the volume of retail sales began to grow again in the first two months of this year.

Possible rebound in GDP in the first quarter

Overall, these signals point to a possible rebound in economic activity at the start of 2016. According to the short-term forecasting models of the PBO, GDP could grow by 0.4 per cent in the first quarter compared with the previous period, before decelerating (towards 0.2 per cent) in the subsequent quarter. The year-on-year increase would be about 1 per cent in the first quarter and slightly below that in the second (Figure 7). On the basis of these projections, in order to achieve an average growth rate of 1.2 per cent in 2016, as assumed by the Government in the 2016, economic activity would have to grow at an average quarter-on-quarter pace of 0.5 per cent per quarter in the second half of the year.

Figure 7 – GDP, forecasts and standard error (1)



Source: PBO
(1) 95 per cent probability.

Inflation turns negative, while inflation expectations diminish

Inflation returned to negative territory at the start of the year, sliding to -0.2 per cent in March and interrupting the modest recovery under way since the spring of 2015 (the harmonised index rose by an average of 0.1 per cent in 2015). The decline in March was mainly driven by the steepening decline in energy prices (-7 per cent), accompanied by a drop in the prices of unprocessed food products (-0.8 per cent). In the light of these developments, the rate of inflation that would be achieved in 2016 if prices remained at their March level for the rest of the year would be -0.4 per cent.

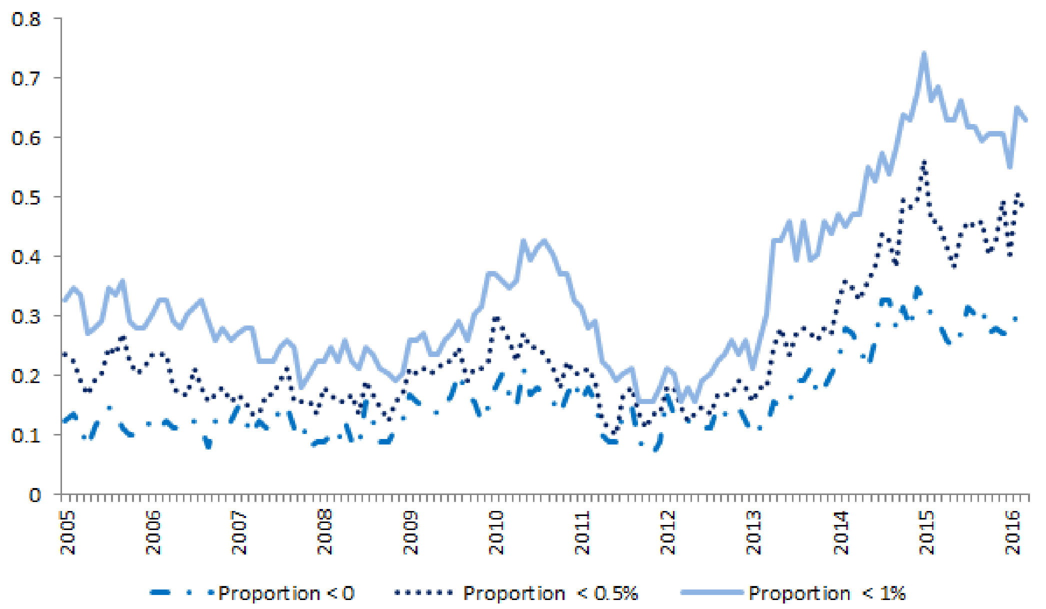
Core inflation (excluding energy and fresh food products) was very low (+0.6 per cent in March) as a result of limited domestic inflationary pressures. The weakening of goods prices continued, while those of services, albeit rising, increased at only a moderate pace and more slowly than in the other main European economies.

Upwards pressures on consumer prices remained weak and limited to a narrow range of the items in the basket composing the harmonised index of consumer prices (HICP) for the Member States of the European Union. The proportion of items whose prices fell declined slightly in March (to 29 per cent). By contrast, the share of goods and services experiencing very low inflation (less than 0.5 per cent) was unchanged. The share of items whose prices rose by less than 1 per cent year on year returned above 60 per cent (Figure 8).

An absence of upwards inflationary pressures continued to distinguish the upstream stages of inflation. The contraction in the prices of industrial products sold on the domestic market (-3.5 per cent in January-February compared with the same period of the previous year) is attributable to the sharp decline in energy prices and in those of intermediate goods. The prices of non-food consumer goods also slowed to a halt at the start of the year (from 0.3 per cent in the fourth quarter of 2015). The contraction in the prices of imported industrial goods also sharpened, entirely attributable to the decline in the prices of energy products and intermediate goods.

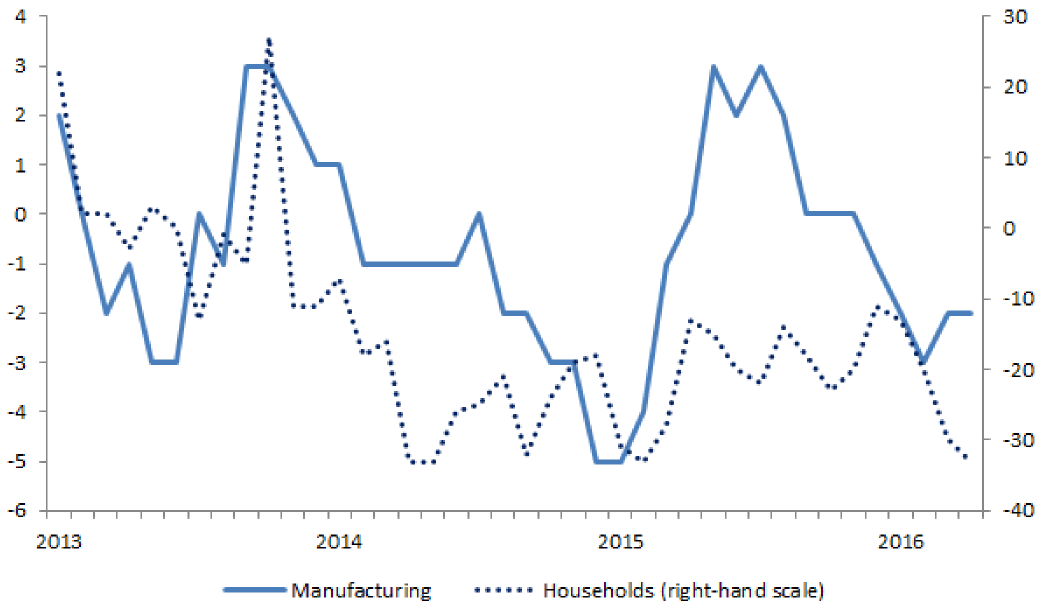
Looking ahead to the coming months, the expectations of households and firms as measured in surveys point to a continuation of price weakness. Short-term expectations signal a steeper decline in the sales prices of market services and in wholesale and retail trade. The producers of consumer goods also expect a decline. Expectations of an increase in prices in the construction sector appear to have subsided after the recovery registered in the first half of 2015. Consumer inflation expectations have fallen even more. The indicator slid to -33 in April, down from -13 in January, as a result of the increase in the proportion of households expecting stable or decreasing prices to about 68 per cent, a rise of 10 points compared with January (Figure 9).

Figure 8 – Proportion of goods and services experiencing deflation or low inflation (as a percentage of total elementary items of the HICP)



Source: based on Istat data.

Figure 9 – Price expectations of manufacturing firms and households (seasonally adjusted balances)



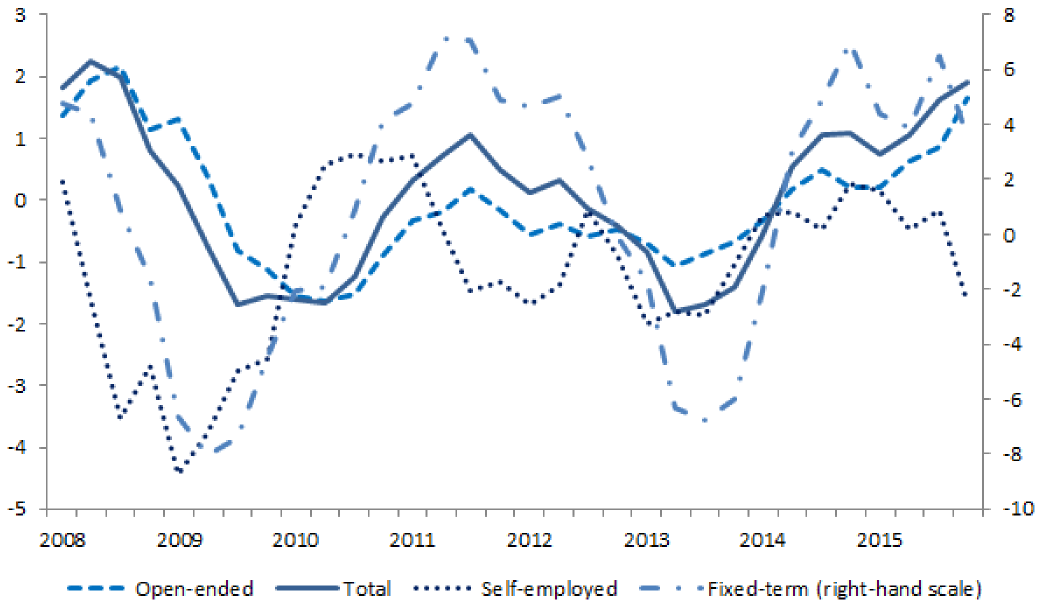
Source: based on Istat data.

The pace of employment picks up at the end of 2015, followed by setback in early 2016

In the labour market, the substantial increase in employment in 2015 (which expanded in line with economic activity both in terms of persons employed as registered in the Labour Force Survey and the standard labour units adopted in the national accounts) mainly reflected the contribution relief granted for workers hired on open-ended contracts and, to a lesser extent, changes in the rules governing individual dismissals. This appears confirmed by both the acceleration during the year in the number of people employed with open-ended contracts as measured by Istat's Labour Force Survey (Figure 10) and by the increase in new registrations net of terminations of open-ended employment relationships measured by the National Social Security Institute (INPS). More specifically, according to the latter, the proportion of newly registered employment relationships that benefitted from contribution relief jumped to 83.5 per cent in December, up from around 60 per cent in the two previous months.

The improvement is also apparent in the flow data drawn from the Labour Force Survey on changes over time in labour market status, which are available up through the fourth quarter of 2015. This data shows an increase in transitions from fixed-term employment to open-ended employment (an increase of +3.5 percentage points between the fourth quarter of 2015 and the fourth quarter of 2014 compared with the same period twelve months earlier). In addition, the likelihood of transitioning from fixed-term employment to other categories of labour market status (unemployed, inactive) continued to decline.

Figure 10– Employment (year-on-year percentage rates of change)



Source: based on Istat data.

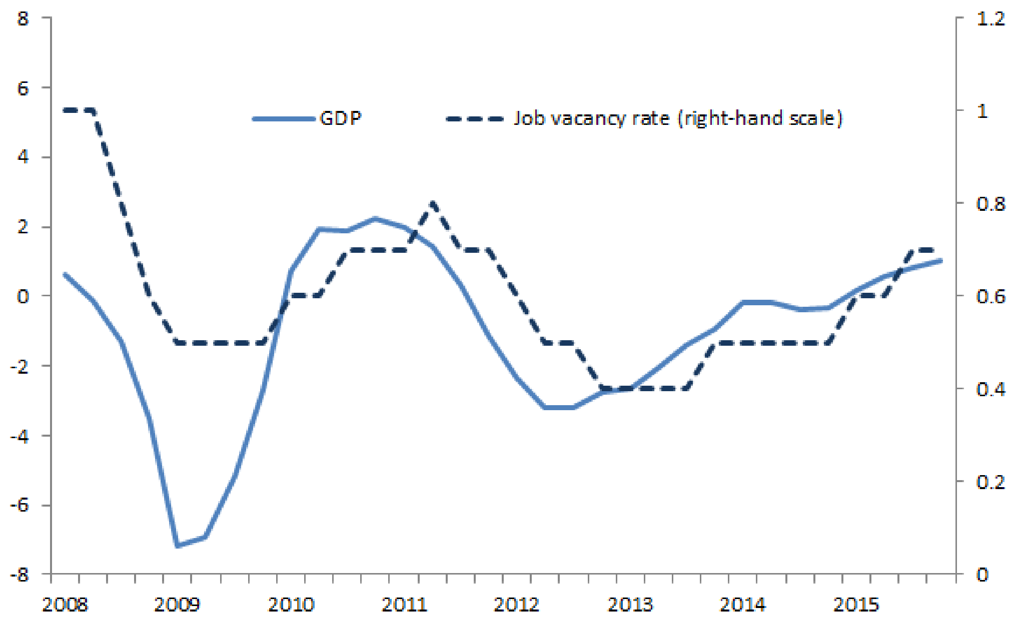
The acceleration in hiring by firms at the end of last year, which was largely prompted by the imminent expiry of the most favourable contribution relief measures (they terminated in December 2015), was reflected in a substantial rise in employment in January 2016 (+0.3 per cent, thanks to a further increase in open-ended payroll employment). However, this uptick was followed by a decrease in the number of employed in February (0.4 per cent, with a decrease of 0.6 per cent in open-ended payroll employment). The average level of employment in January-February was just below the average for the fourth quarter of 2015 (by about 12,000 units). INPS data also showed that after the peak reached in previous months, new registrations net of terminations also contracted (-76.000), with the decline entirely attributable to the decrease in new open-ended positions. A similar, albeit smaller, weakening affected transformations of existing employment relationships (a decrease of 7,400 in the first two months of 2016, following an increase of more than 150,000 in November-December 2015).

With regard to unemployment, following the decline registered in the third quarter of 2015, the percentage of people without a job stabilised. In the first two months of 2016, the unemployment rate was essentially unchanged on its December level (11.7 per cent). The improvement in labour market conditions was reflected in a decline in the likelihood of remaining unemployed. According to flow data available up through the fourth quarter of 2015, the rate of long-term unemployment had decreased by more than 5 percentage points on the previous year (from an estimated 42.4 per cent between the fourth quarter of 2014 and the fourth quarter of 2015), while the likelihood of finding employment increased (by 2.1 percentage points, from the 21.1 per cent between the fourth quarter of

2014 and the fourth quarter of 2015). At the same time, the likelihood of becoming inactive also rose.

Overall, the outlook for the labour market in the rest of the year remains positive despite the initial setback registered following the acceleration in hiring at the end of 2015. The April survey findings reveal generally positive expectations for employment among firms, especially in industry and construction. In the trade sector, despite a sharp correction in April, short-term expectations were higher than the average for the first quarter. By contrast, expectations for employment levels in market services were unchanged (for the third month in a row). After the significant increase in response to developments in economic activity (Figure 11), labour demand is expected to moderate while maintaining a positive trend.

Figure 11 – GDP and job vacancies
(year-on-year percentage rates of change and percentages)



Source: based on Istat data.