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Summary*

The Italian recovery is continuing at a moderate pace. Based on the available economic indicators, the PBO estimates that GDP expanded by about 0.2 per cent in the fourth quarter of 2016. The forecasts for the first quarter of 2017 point to a more modest increase, amounting to about 0.1 per cent. These estimates imply a rise of 0.9 per cent in GDP in 2016, compared with a forecast in the DBP, in October, of 0.8 per cent. For 2017, achieving the growth target in the DBP (1 per cent) would require GDP to accelerate as from the second quarter to an average pace of 0.4 per cent.

Growth continues to be driven by domestic demand, but with the leading component shifting from consumption to investment. Household spending has slowed recently, while investment has been more buoyant. The latter has been impacted by the rise in corporate profitability, thanks in part to moderation in production costs, and the stimulus provided by government incentives. Credit conditions, while still very selective, are slowly improving. The consequences of the recent downgrade of sovereign debt for the financing of banks by the ECB are expected to be modest (the PBO estimates that the decline in the value of collateral would be 2.5 per cent of the total value of the assets that banks pledge as security). The more favourable investment conditions have been translated in company plans into initiatives aimed not so much at expanding their production base as at increasing efficiency. This partly runs counter to developments in other European countries. For Italian companies, this difference may reflect a less favourable outlook for demand and the need for plant upgrading following the long period of crisis.

In the labour market, employment growth has stabilised and the effects of contribution relief policies on open-ended hiring have weakened significantly. The increase in the price of oil and the depreciation of the euro have spurred inflation. The weak upturn in demand and wage moderation are still containing domestic price pressures.

The developments in Italy are taking place in an improving global environment. The IMF has substantially confirmed its forecasting scenario, expecting a stronger US acceleration as a result of more expansionary fiscal policies. However, the United States has become a major source of uncertainty for the rest of the world. Questions about the measures that the new President will take in the area of trade policy and the reaction of the Federal Reserve in the event of economic overheating are having an impact.

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* *Prepared by the Macroeconomic Analysis Department. Information updated to 29 January 2017*

The international environment

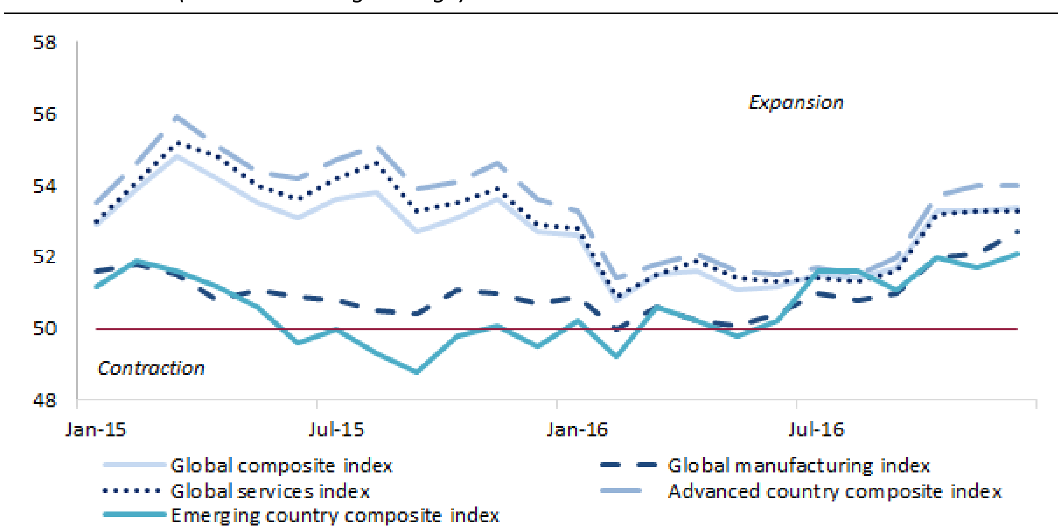
Signs of improvement for the world economy...

After expanding slowly in the first half of last year, global economic activity improved gradually in the remainder of 2016, mainly driven by faster growth in the advanced economies, while that in the emerging countries was broadly stable.

The recovery accelerated in the United States during the first three quarters of 2016 before slowing in the final months of the year, partly due to the slowdown in net exports. By contrast, growth weakened in Japan, while maintaining a moderate pace in the euro area. In the United Kingdom, the outcome of the referendum on remaining in the EU has not produced the feared adverse impacts on economic activity, with growth continuing since the summer. Nevertheless, uncertainty persists about the possible adverse effects of Brexit on the UK economy in the longer term, which will depend on the relationships to be established with the EU. Among the emerging countries, growth was essentially stable in China and India, while recession has persisted in the other major economies (Argentina, Brazil, Turkey). The decline in economic activity has eased in Russia, thanks to the rise in energy prices.

The available economic indicators reveal the continuation of more vibrant growth in the global economy at the close of last year and the beginning of 2017. Output growth is expected to continue in the United States and could strengthen in the euro area compared with its pace in recent quarters. The Purchasing Managers' Index (PMI) for the global economy continued to improve in the final months of 2016, mainly reflecting better performance in the advanced countries. At the sectoral level, conditions in manufacturing were relatively more favourable (Figure 1).

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

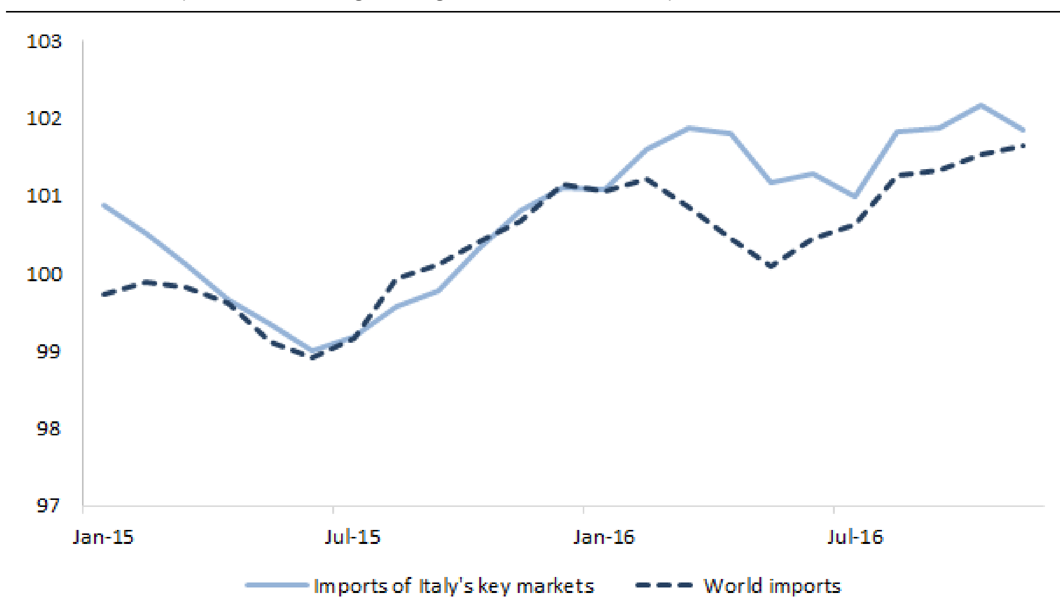


Source: Thomson Reuters.
(1) Confidence indicators based on the assessments expressed by corporate purchasing managers.

... but the expansion of trade remains slow

The revival of global output was reflected only in part in international trade, which, although improving from the negative performance of the first part of 2016, accelerated at too moderate a pace to change the modest average performance for the year as a whole (Figure 2). It is estimated that world imports of goods increased by about 1 per cent in 2016. Taking account of the relative weight of destination markets, the expansion of the key markets for Italian products was stronger, but remained very slow (estimated at less than 2 per cent). The weak growth in world trade reflects the loosening of the relationship between economic activity and trade in recent years. As discussed in the Report on recent economic developments in October, this phenomenon has reflected both cyclical and structural factors (a decline in the international fragmentation of production processes, an easing of the impact of technological progress on transportation, the fading of the effects of past liberalization efforts). In recent months, an additional element of risk has been the potential trade policies that could be adopted by the new US administration to protect domestic production. The possible spread of trade restrictions on an international scale, through a tit-for-tat sequence of protectionist actions and reprisals, would further constrict the volume of global trade.

Figure 2 – World imports and Italy's key markets
(3-month moving average; indices, 2015=100)



Source: based on Thomson Reuters data.

World growth in IMF forecasts

In the January update of its forecasting scenario, the International Monetary Fund (IMF) basically confirmed the projections for growth in world output issued in October for both 2017 and 2018. Growth in global economic activity is expected rise to 3.4 per cent this year (3.1 per cent in 2016) and 3.6 per cent in 2018 (Table 1). The confirmation of the forecasts for the world economy reflects slight upward revisions of growth in the developed countries (one-tenth of a point, to 1.9 per cent, in 2017 and two-tenths of a point, to 2 per cent, in 2018). The latter, in turn, mainly reflect the increase in US growth forecasts (one-tenth of a point, to 2.3 per cent, in 2017 and four-tenths of a point, to 2.5 per cent, the following year), associated with the expansionary fiscal policies announced by President Trump. The forecasts for the expansion of world trade were kept unchanged compared with the October projections for the current year (3.8 per cent), while the outlook for 2018 was revised slightly downward (by one-tenth of a point, to 4.1 per cent).

The prospects for a gradual improvement in international growth are clouded by widespread uncertainty, however. This is mainly associated with the question marks that still surround the economic policy approach that will be pursued by the new US administration.

The magnitude of the expected acceleration in US growth will depend not only on the scale but also the composition of the fiscal stimulus. The expansionary effect of an increase in the budget deficit could be limited if it is accompanied by measures, including both tax cuts and reductions in transfer spending, that redistribute income to the wealthiest segments of the population, which have a lower propensity to consume. Another factor will be the monetary policy stance adopted by the Federal Reserve. A tightening of monetary conditions in response to any signs of overheating could affect financial markets in Europe and in the emerging countries. These risk factors are accompanied by the uncertainty about the trade policies that the United States might adopt and the reaction that they could trigger in other economies.

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

	WEO update January 2017		Difference with WEO October 2016	
	2017	2018	2017	2018
World output	3.4	3.6	0.0	0.0
Advanced economies	*1.9*	*2.0*	*0.1*	*0.2*
United States	*2.3*	*2.5*	*0.1*	*0.4*
Euro area	*1.6*	*1.6*	*0.1*	*0.0*
Emerging economies	*4.5*	*4.8*	*-0.1*	*0.0*
World trade	3.8	4.1	0.0	-0.1

Source: IMF, *World Economic Outlook (WEO) Update*, January 2017.

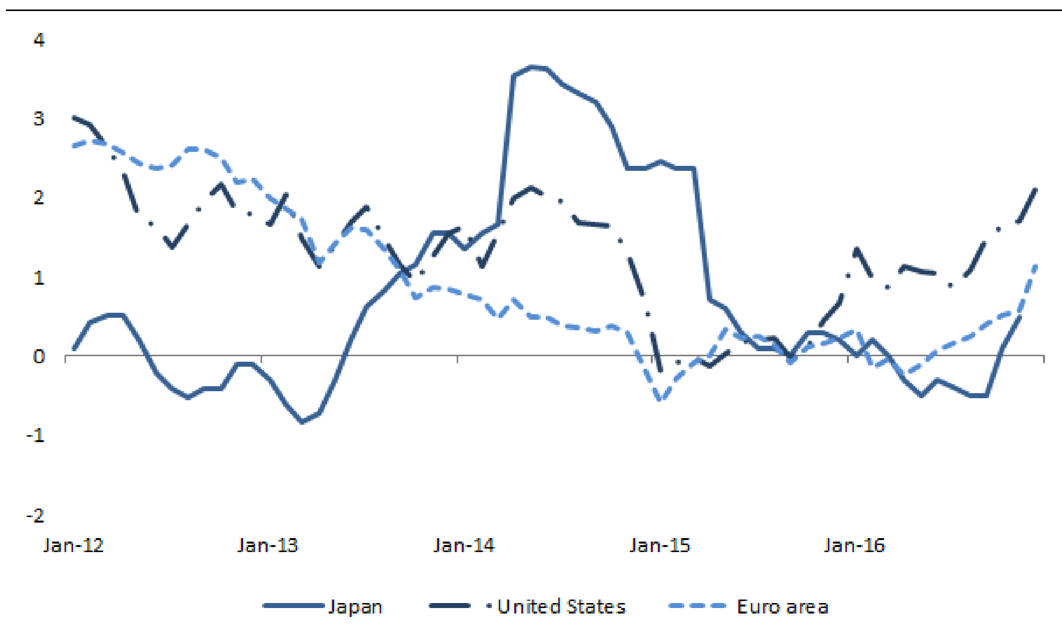
Oil and the exchange rate are putting pressure on European inflation; the ECB confirms its expansionary stance

The agreement reached at the end of last November by the oil-producing countries to reduce the supply of crude, caused a jump in the price of Brent. In January, the quoted price was around $55 per barrel, an increase of about 20 per cent compared with November. The rise in the prices of industrial raw materials was less pronounced. By contrast, food prices declined slightly. Overall, the total index of raw materials prices rose significantly compared with twelve months earlier, and the impact on inflation in importing countries has begun to appear in both current prices and expectations.

In the euro area, the intensification of inflationary pressures has been fuelled not only by increases in the prices of raw materials but also by the strong appreciation of the dollar against the euro following the election of Trump. The strengthening of the American currency was affected by expectations of a change in the policy mix in the United States later this year (with a more restrictive monetary policy in response to a more expansionary fiscal policy). In January, the value of the euro against the dollar had declined by about 4 per cent compared with the period preceding the US elections. Given the concomitant weakening experienced by the emerging market currencies, the yen and the pound sterling against the euro, the euro's depreciation in nominal effective terms was substantially smaller (about 1 per cent).

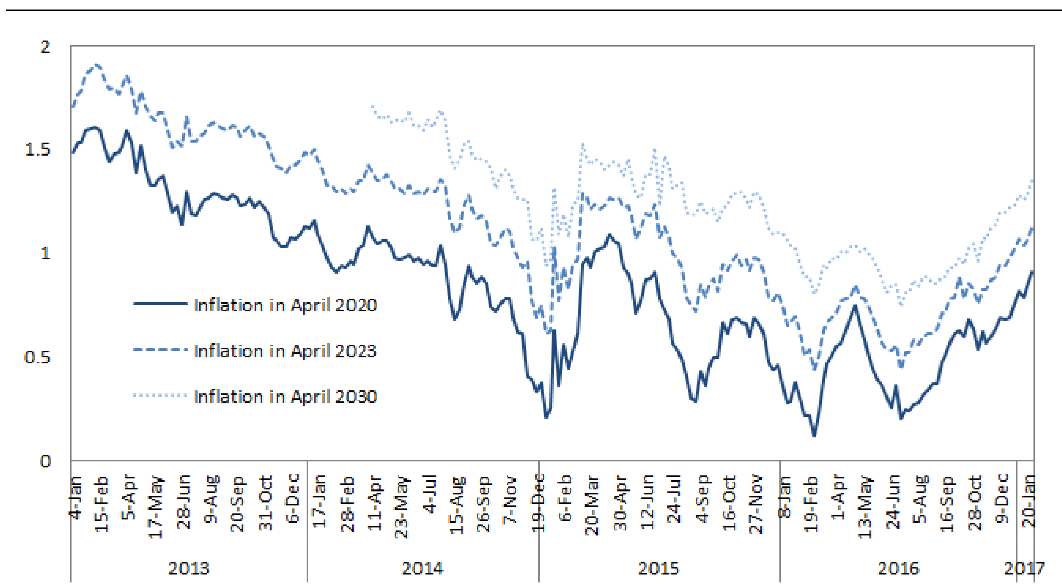
Following these developments, euro-area inflation gradually began to rise, reaching 1.1 per cent in December (compared with 0.6 per cent in November, Figure 3). Excluding, energy products and food, however, the acceleration in consumer prices was small (0.9 per cent in December, compared with 0.7 per cent in November). Signs of a resurgence in inflation are also found in inflation expectations, as inferred from the break-even inflation rate calculated on ordinary German government securities and those linked to euro-area price inflation (Figure 4). The rise is very gradual, however. Inflation expectations have returned to levels last seen in early 2015, at the start of the ECB's quantitative easing programme. They therefore remain substantially distant from values that would be consistent with the objective of price stability. In view of these developments, at the January meeting of its Governing Council, the ECB confirmed that it will retain its asset purchase programme at least until December 2017 and that official interest rates will not rise for an extended period of time, and well past the horizon of the quantitative easing measures.

Figure 3 – Inflation
(year-on-year annual changes)



Source: Thomson Reuters.

Figure 4 – Inflation expectations in the euro area: break-even inflation
(yield differential between ordinary and inflation-linked Bund; percentages)



Source: Bundesbank.

The Italian economy

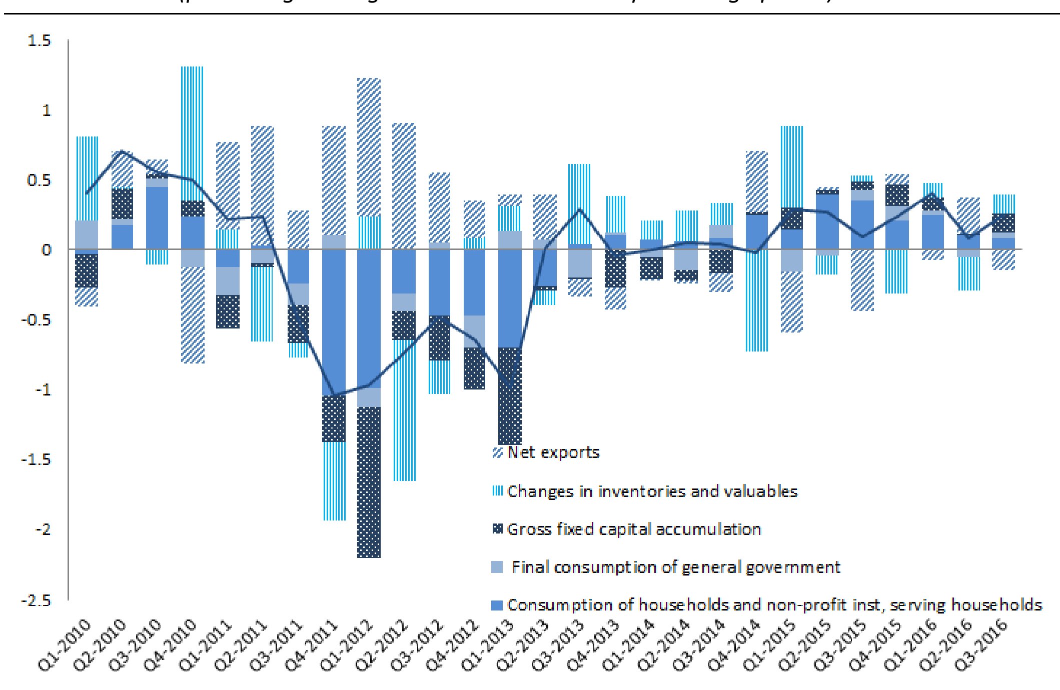
The recovery continued at a modest pace in the third quarter

Despite the weakness of international trade, Italian GDP growth in the third quarter of 2016 (0.3 per cent compared with the second quarter and 1 per cent year on year) gained strength after the slowdown registered in the previous three months, driven by domestic demand. Based on the latest national accounts data released by Istat last December, this increase, the fifth in a row, brought growth for 2016 to 0.9 per cent.

On the supply side, the positive trend in the third quarter mainly reflected the recovery in industry excluding construction (1.1 per cent on the previous period) after the overall decline posted in the spring months. By contrast, services registered weak growth (0.1 per cent), while construction contracted slightly (-0.2 per cent).

As for the components of demand (Figure 5), domestic spending makes a positive contribution (about 0.3 percentage points, equally distributed between household consumption and investment), as did changes in inventories (equal to 0.1 percentage point). By contrast, net exports subtracted about 0.1 percentage points from growth, as imports increased on the previous period (0.7 per cent) by more than exports (0.1 per cent).

Figure 5 – 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.

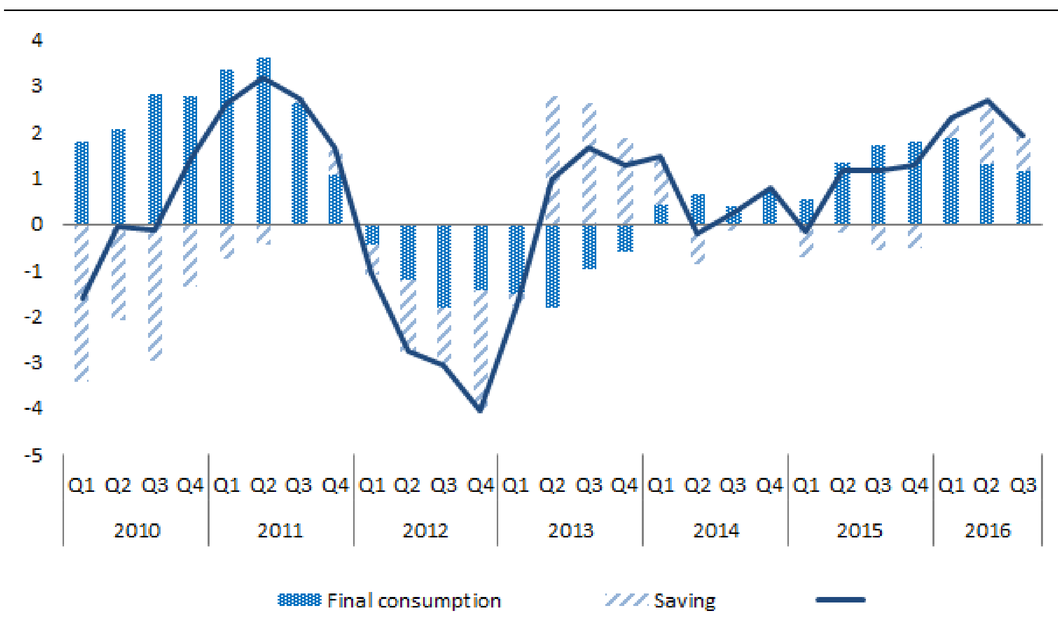
Consumption growth slows...

The slowdown in private consumption growth observed in the second quarter continued in the third (0.1 per cent on the previous quarter), reflecting the slowdown in purchases of durable goods and, for the second consecutive quarter, essentially flat purchases of non-durables. The modest increase in consumption expenditure was affected by the slowdown in the purchasing power of households (which rose 0.2 per cent on the previous quarter) compared with the high growth rates (around 1 per cent) registered in the first half of 2016.

Households' average propensity to save remained broadly unchanged over the previous quarter, standing at a level (9.3 per cent of disposable income) that, although still below the averages that distinguished the period prior to the last recession (12 per cent), is about one percentage point higher than the figure for 2015. The rise in the savings rate in the first three quarters of 2016 (Figure 6) may have reflected the gradual decline in household confidence from the highs posted at the beginning of the year in response both to the general economic situation and to personal circumstances. This decline may have been accompanied by a more prudent approach to consumer spending.

On this front, January survey data point to a further fall in confidence after a rebound in December, although the upward revision of assessments of the state of personal finances continued for the fourth consecutive month. The most favourable view of personal finances, with the attenuation of a number of factors of uncertainty such as home values and unemployment fears, could help sustain household spending in the coming months.

Figure 6 – Household Income, consumption and saving
(year-on-year percentage changes)



Source: based on Istat data.

... but investment recovers

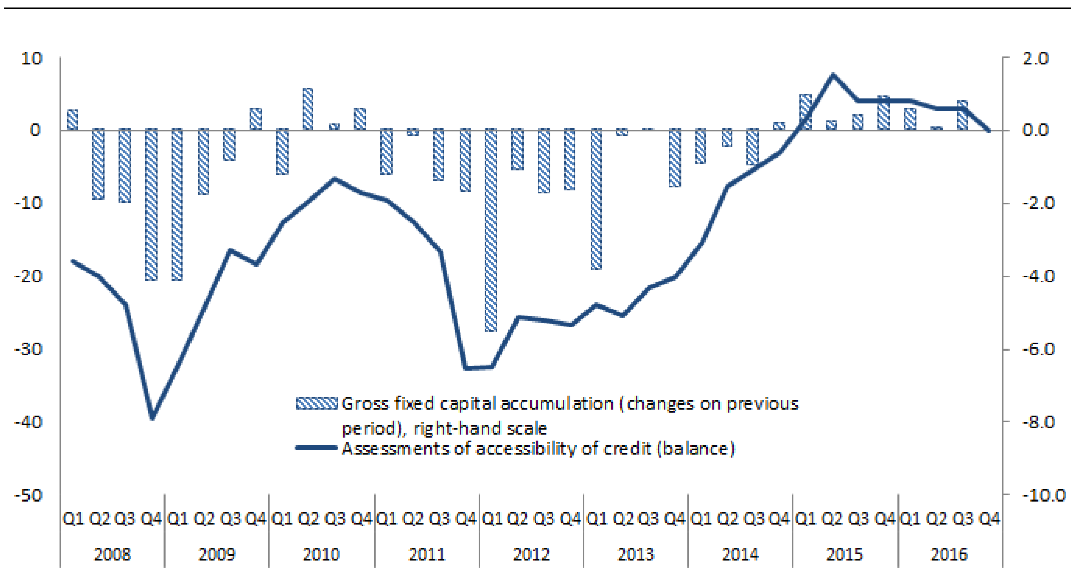
Capital accumulation picked up in the third quarter (rising by 0.8 per cent on the previous quarter) after having slowed in the second, which had interrupted the moderate recovery that began in the latter part of 2014. The growth in gross fixed investment was driven by the favourable performance of machinery and equipment (0.7 per cent) and the jump posted by transport equipment (8.8 per cent), which probably continued to benefit from the tax benefits linked to the deductibility of depreciation and lease payments. However, signs of weakness emerged in construction investment, which again posted a slight decline (-0.2 per cent).

The gradual recovery in investment, after the sharp drop registered during the crisis, should continue in the coming months. Incentives to reduce the cost of capital and those for purchases of high-tech equipment are factors boosting to the propensity to invest and have been welcomed enthusiastically by firms.

The environment of gradual improvement is also confirmed by profitability indicators, which have continued to rise thanks to the moderation of production costs. Credit conditions also remain relatively more favourable than in recent years. Nevertheless, the improvement appears to be very gradual, as highlighted by the broad stabilization in recent months of the assessments of manufacturing firms of the accessibility of credit (Figure 7). On the supply side, the Bank of Italy survey of banks reveals substantial stability in credit conditions in the fourth quarter of 2016, which, as supported by the findings of ISTAT business surveys, remain selective and differ depending on firm size and sector of activity (with more favourable conditions for larger manufacturing firms and firms in the services sector, less so for smaller firms or those in the construction sector). The cost of credit, which was stable in November 2016 at historically low levels, should not be affected by the downward revision of the rating assigned by DBRS to Italian government securities, which should only have a modest overall impact on the ability of Italian banks to access refinancing with the Eurosystem (see Box "Effects of the downgrade of Italian sovereign debt on bank refinancing with the ECB").

The precautionary measures approved in December by the Government, with the establishment of a fund of up to €20 billion to support of the liquidity and capitalization requirements of banks, help to reduce the threat to financial stability, fostering the flow of credit to the economy.

Figure 7 – Change in manufacturing investment on the previous quarter and assessments of credit conditions
(percentage changes and percentage balance)



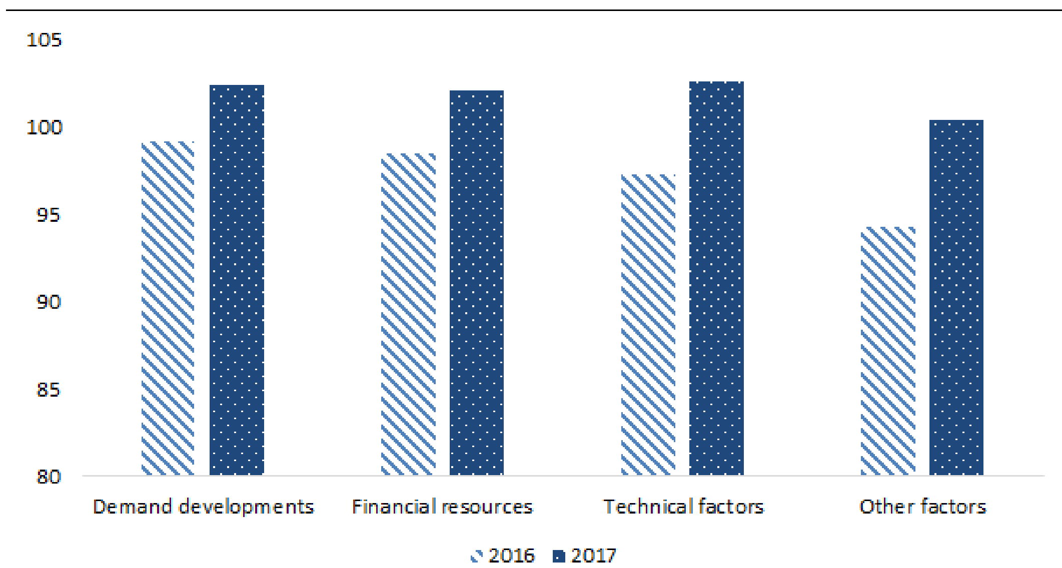
Source: based on Istat data.

Istat's latest semi-annual survey on the investment plans of manufacturing firms indicates a gradual recovery of confidence among firms who reported plans to proceed with investments in the current year (Figure 8). Compared with 2016, there has been a broadly based improvement in views concerning developments in demand, capacity utilization and the outlook for sales, as well as the availability of financial resources and profit expectations. Assessments of technical factors, such as labour availability and the adaptability of labour to new technology are also well above their long-term average. Moreover, assessments of other factors (such as, for example, tax policy) have also been revised sharply upwards, reaching a position above their long-term level for the first time in about a decade.

However, the more favourable investment climate reported by firms appear primarily to be driving initiatives to improve, rather than expand, the production base. This trend This trend partly runs counter to developments found in similar surveys conducted in other European countries. Firms interviewed in Italy confirm for the current year the prevalence of plans to replace and/or upgrade obsolete equipment and rationalization measures to automate existing production processes (Figure 9).

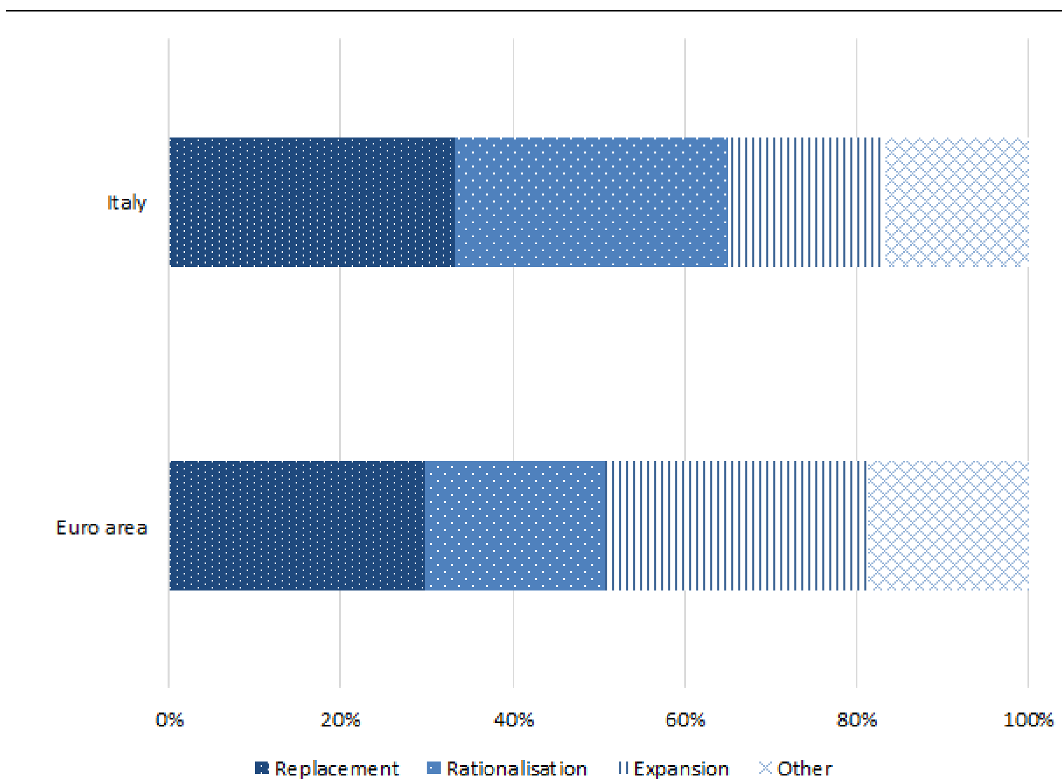
By comparison with the euro-area average, the share of investment directed at expanding production capacity appears to be relatively modest, as does that for other expenditure (environmental protection, waste management, safety). The different Italian propensities for the various investment categories may reflect expectations of a smaller increase in demand than in other European countries and, at the same time, the need to upgrade and increase the efficiency of production capacity that has deteriorated over the prolonged period of crisis.

Figure 8 – Positive factors impacting manufacturing investment
(2000-2017 average = 100)



Source: based on Istat and European Commission data.

Figure 9 – Planned purpose of manufacturing investment in 2017
(percentage shares)



Source: Istat and European Commission.

The latest economic indicators

After the setback in October, industrial production gathered pace in November (0.7 per cent on the previous month), driven by the strong performance of intermediate and capital goods. Even allowing for a partial retrenchment in December, the PBO estimates that industrial activity increased on average in the fourth quarter of 2016 by 0.5-0.6 per cent over the third quarter. The performance indicators in industry in the first few months of 2017 remain positive, with a slow pace of expansion in line with that in the final part of 2016. The most recent developments in turnover and orders confirm the gradual improvement that has emerged since the central months of the year. Both indices show an increase in both the domestic and foreign components, reflecting the broad stability of domestic demand and the good performance in foreign markets, which has been buoyed by gains in competitiveness in the second half of the year .

By contrast, the construction sector remains highly erratic: in November, the volume of production jumped by 2 per cent compared with October after the monthly declines in the previous two months, reaching a level close to the average for the last two years. Very encouraging signs can be seen in the performance of sales, which continued to grow strongly on average in the third quarter (17.8 per cent on the year-earlier period). The persistence of especially favourable conditions in the mortgage market, against a background of gradually stabilising real estate prices, point to growth for the sector in the coming months.

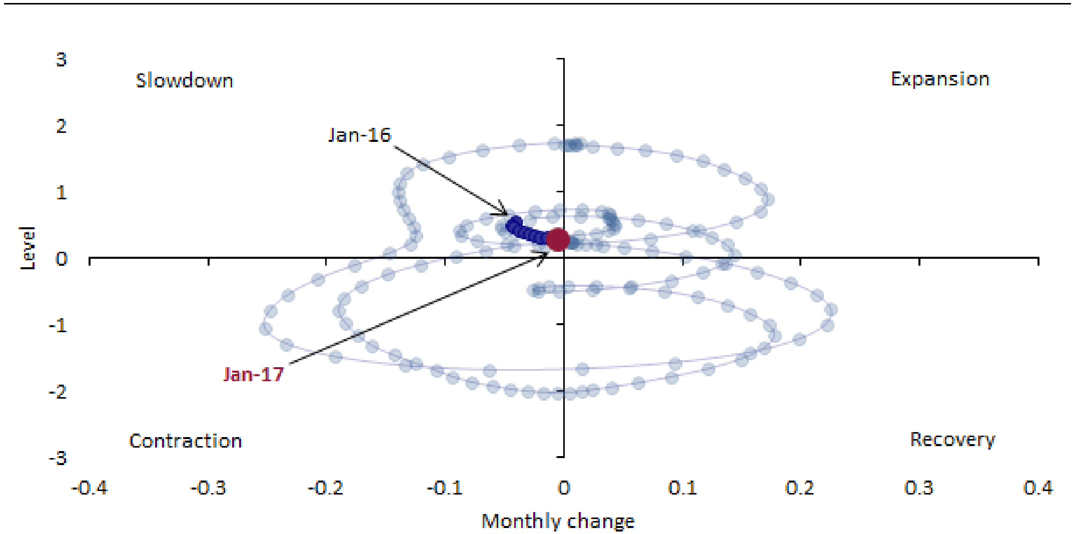
The recovery in services that began in the second half of 2014 continues, albeit slowly: compared with the average for the summer months, the index of services in value terms rose slightly in the third quarter (0.1 per cent), fuelled mainly by the jump in hotel and accommodation services (3 per cent over the previous quarter), offset by a decline in transportation and storage (-0.9 per cent). Developments in retail sales were irregular and subdued, as reflected by the sector index in November, which was close to its average for the last two years, and by the Confcommercio consumption indicator, which rebounded after the slight decline posted the previous month.

For all productive sectors, the most recent indications drawn from the Istat Economic Sentiment Indicator (IESI) show a relatively high level of confidence compared with the long-term average, but one that is moving only very slowly towards full recovery, as revealed by developments in the indicator in a representation of the different cyclical phases in quadrants (Figure 10).[1]

[1] The four quadrants can be described as follows: above average and accelerating (upper right-hand quadrant, expansion), above average and slowing (upper left-hand quadrant, slowdown), below average and slowing (lower left-hand quadrant, contraction) and below average and accelerating (lower right-hand quadrant, recovery). The composite confidence indicator was filtered using the Hodrick-Prescott procedure to eliminate short-term fluctuations (less than 18 months) and subsequently normalised (i.e. making it zero mean and unit variance). The series so obtained was represented graphically together with changes on the previous month. The segment in blue regards developments in the months of 2016. The value for the final figure is shown in red. The same procedure was used for the climate of confidence by sector (Figure 11).

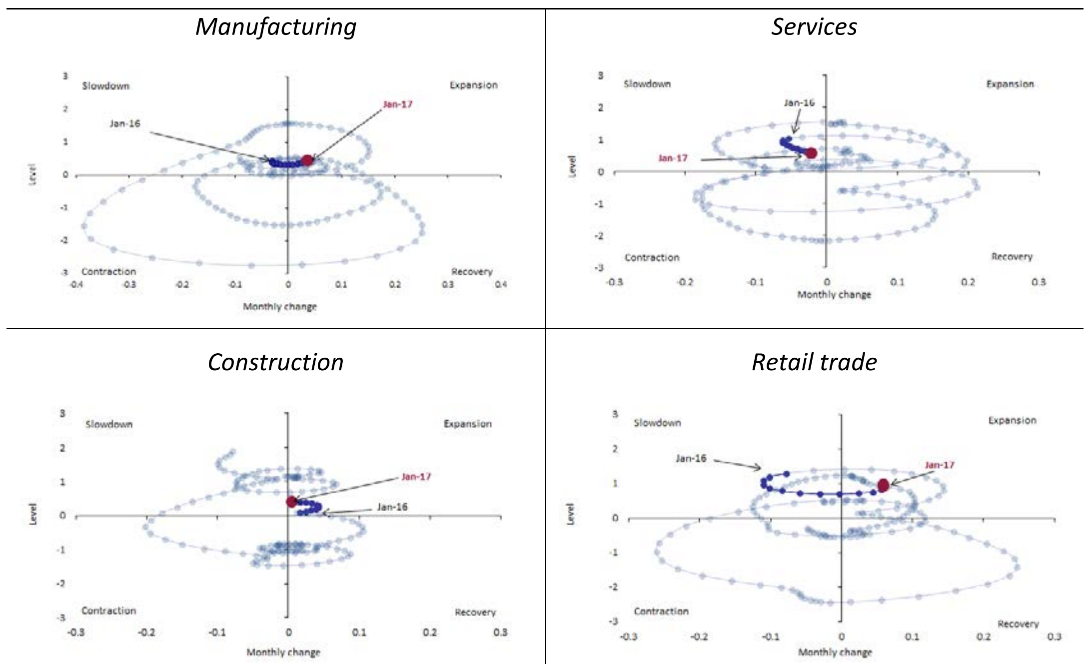
At the sectoral level, manufacturing and retail trade display the most favourable dynamics, shifting from the cyclical slowdown quadrant to expansion, while developments in the confidence indicator in services are similar to those in the composite indicator. By contrast, the indicator for construction moved in the opposite direction, shifting within the expansion quadrant towards a slowdown (Figure 11).

Figure 10 – Cyclical dynamics of the IESI
(cyclical deviations in levels and their change on the previous month)



Source: based on Istat data.

Figure 11 – Cyclical dynamics of climate of confidence by sector
(cyclical deviations in levels and their change on the previous month)



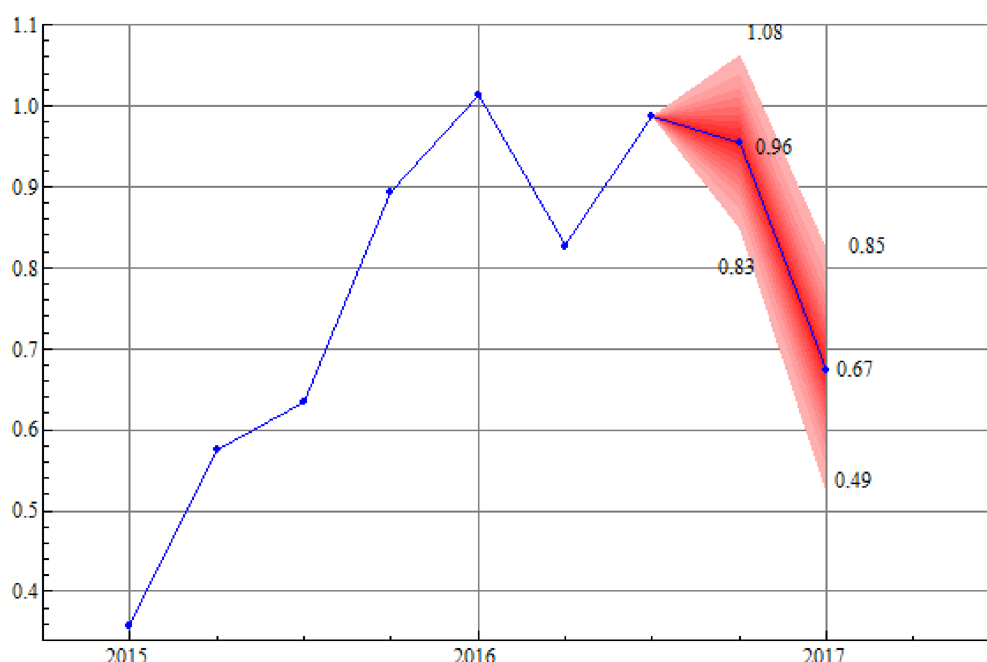
Source: based on Istat data.

Short-term forecasts

Overall, the economic indicators paint a picture of a slow recovery in economic activity in the coming months. Based on the estimates generated with the PBO's short-term models, GDP grew by about 0.2 per cent in the fourth quarter compared with the previous three months, while the forecast for the current quarter, characterized by greater uncertainty, indicates only a modest increase (0.1 per cent). Year-on-year GDP growth in the two quarters in the forecasting period is estimated at about 1.0 per cent and 0.7 per cent respectively (Figure 12).

These estimates point to average GDP growth of 0.9 per cent in 2016, based on data adjusted for the number of working days. Growth in 2016 would be 0.9 per cent even adjusting for the lower number of working days (two) compared with 2015. The October forecast in the Draft Budgetary Plan (DBP) for growth in 2016 (unadjusted for the number of working days) was 0.8 per cent. Taking account of the PBO projection for the first quarter of 2017, the growth that would be achieved this year if GDP remained stable for the rest of the year would be around 0.4 per cent. Accordingly, to achieve growth of 1 per cent this year, as assumed in the DBP, the Italian recovery would have to accelerate as from the second quarter, with average increases in GDP in subsequent quarters of 0.4 per cent.

Figure 12 – Short-term GDP forecasts and standard error (1)
(year-on-year percentage changes)



(1) 95 per cent probability.

Employment growth slows

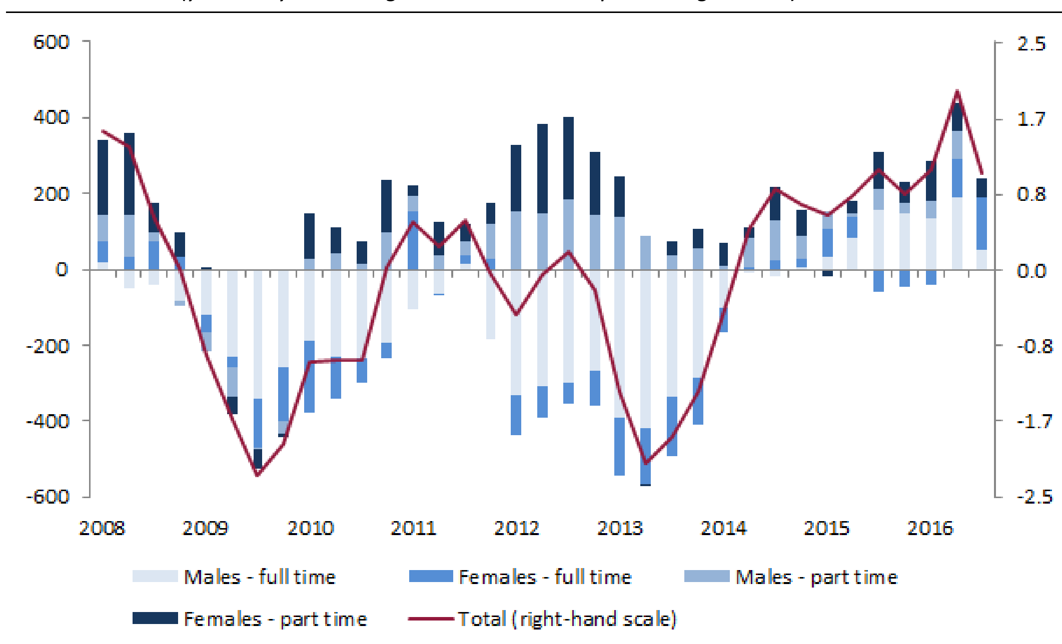
Employment growth registered a marked deceleration in the summer months. According to the Labour Force Survey, the number of persons employed in the third quarter was largely unchanged compared with the previous three months. This stagnation reflected a substantial decline in self-employed workers (-1.5 per cent, after an increase of 1.1 per cent in the second quarter), offset by an increase in payroll employment (0.4 per cent). The performance of the latter reflected the slow growth in open-ended employment (0.3 per cent) and the more rapid, albeit slowing, expansion in fixed-term employment (0.8 per cent, down from 3.1 per cent in the second quarter). The overall weakness in employment reduced the increase on a year-on-year basis to 1.1 per cent in the third quarter, about 1 percentage point lower than the figure posted in the previous three months. The female component made a major contribution to sustaining employment levels, especially for part-time employment (a year-on-year rise of 1.6 per cent), more than offsetting the slowdown in male employment (Figure 13).

In October-November 2016, the evolution of employment was still weak (-0.1 per cent on the previous three months), essentially the result of a contraction in payroll employment (-0.3 per cent). The decline in the latter reflected reductions in both open-ended employment (-0.2 per cent) and fixed-term jobs (-0.5 per cent). By contrast, self-employment increased (0.6 per cent). The stagnation of employment in the second half of 2016 partially offset the increases recorded in the first six months. On average, in January-November 2016, the number of persons in employment rose by 1.2 per cent overall compared with the same period of 2015.

Over the course of 2016, the gradual deceleration in open-ended employment was at least partly connected with the dissipation of the effects of contribution relief measures as a result of the reduction in the exemption for employers. The increase in the prevalence of fixed-term employment reflected the behaviour of labour demand, which is currently more focused on temporary jobs, at least until the outlook for recovery strengthens.

Evidence supporting these assessments can be found in data from the Observatory on Insecure Employment of the National Social Security Institute (INPS). The flow data for changes in employment relationships (new hires, transformation of contracts, terminations) in 2016 continued to show net growth in new jobs, albeit at a less rapid pace compared with 2015. In the period from January to November last year, the positive balance between new hires and terminations fell to 567,103 labour units (-17.6 per cent compared with the same period of 2015, amounting to about 121,000 fewer jobs). This was the result of a larger decrease in new hires (-5.7 per cent) than in terminations (-4 per cent). The contribution of open-ended employment to the total net change was modest (about 66,000 contracts, equivalent to one-tenth of the balance recorded in the corresponding period of 2015). New open-ended jobs (-32.3 per cent on the previous year) and transformations of fixed-term jobs and apprenticeships to open-ended positions (-30.3 per cent overall) slightly outpaced the flow of terminations (down 7 per cent).

Figure 13 – Full-time and part-time employment, by gender
(year-on-year changes in absolute and percentage terms)

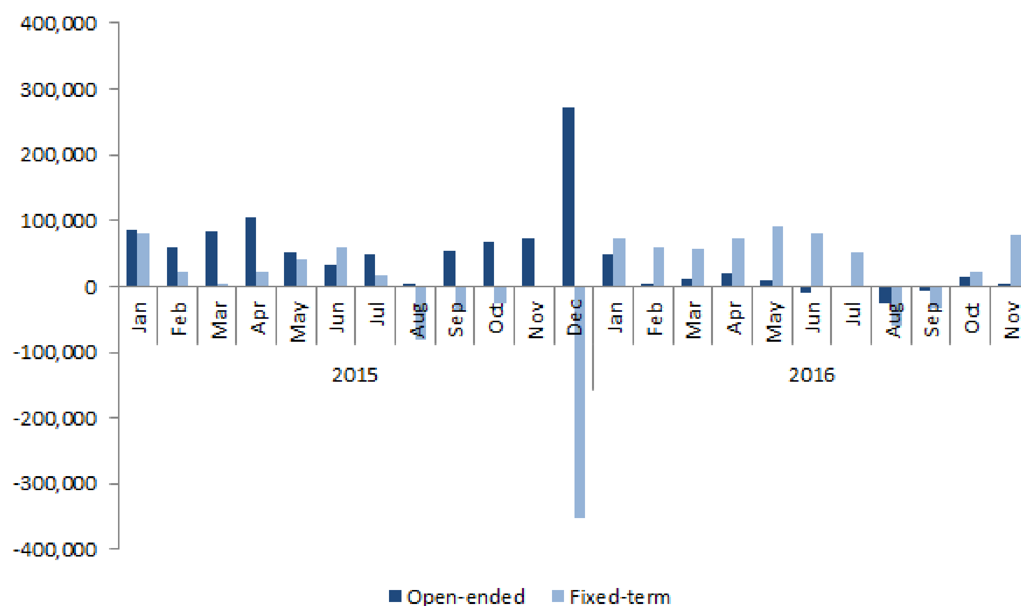


Source: based on Istat data.

The introduction in 2016 of less generous contribution relief appears to have reduced the attractiveness of open-ended hiring. This phenomenon is evident in the profile of net changes in employment relationships over the past two years (Figure 14). In December 2015, when full contribution relief expired, an exceptional number of open-ended contracts were registered (about 490,000), compared with a sharp rise in terminations of fixed-term positions. Since the start of 2016, the net change in open-ended hiring has gradually declined, turning negative in the middle months of the year. This performance also reflected a decline in open-ended hiring and transformations to open-ended contracts that benefitted from the less favourable contribution relief measures (in January-November they fell to 34.4 per cent of all open-ended new hiring and transformations, virtually half the proportion registered in the same period of 2015). The overall flow of new payroll employment in 2016 seems to have been largely driven by the improvement in temporary hiring in the labour market. In the period from January to November, registrations of new fixed-term contracts increased by 13.1 per cent over the same period of 2015, compared with a slight decline in terminations (-1 per cent); the corresponding net change reached 492,000 labour units. New hiring under apprenticeship arrangements also posted a substantial rise (57.1 per cent), with the net change returning positive thanks to the reduction in terminations (-12.3 per cent).

On the unemployment front, the increase in the number of job-seekers in the third quarter of 2016 was modest (0.3 per cent), decelerating compared with the previous three months. The rise is essentially attributable to the male component (0.7 per cent), while the female component contracted (-0.2 per cent).

Figure 14 – Net changes in payroll employment



Source: based on Istat data.

With the stagnation in the number of persons in employment, the increase in unemployment reflects greater participation in the labour market. The decrease in inactive individuals (down 0.2 per cent) is entirely attributable to women (-0.3 per cent), as there was no change in the male component, and involved both people available to work (the potential labour force) and those further from labour market. This led to a reduction in gender disparities in labour market participation. Reflecting these developments, the unemployment rate stood at 11.6 per cent for the fifth consecutive quarter.

According to the most recent surveys, in October-November the unemployment rate rose slightly (to 11.9 per cent on average for the two months). This reflected an increase in the number of job-seekers (2.1 per cent compared with the third quarter), attributable entirely to the male component of the labour market.

International factors cause inflation to rise; domestic pressures remain weak

In the final months of 2016, consumer price inflation turned positive, rising marginally in November (0.1 per cent compared with the same period of 2015) and accelerating in December (0.5 per cent). However, these rises were not sufficient to bring the annual average rate into positive territory (-0.1 per cent).

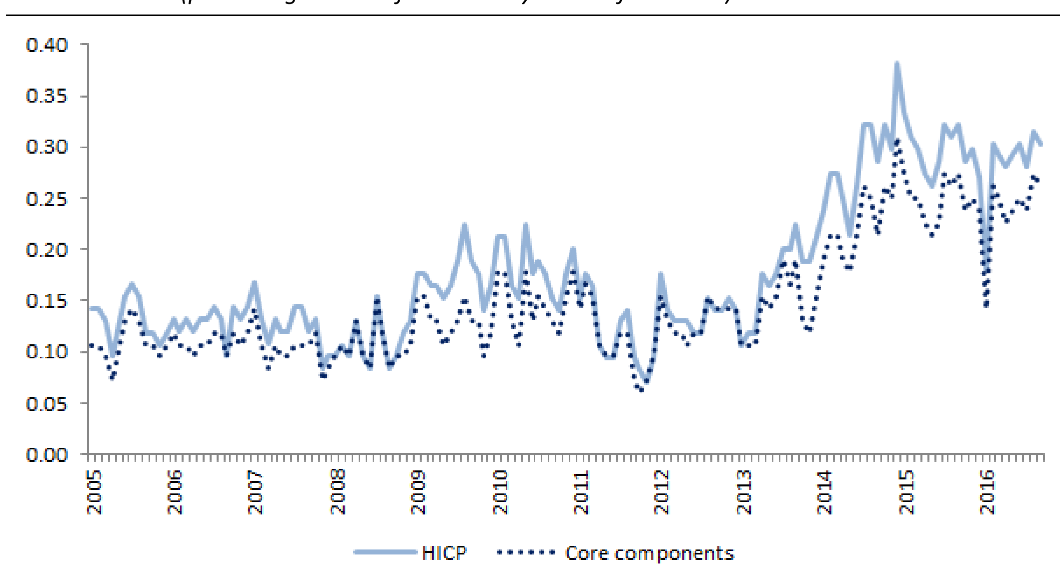
The acceleration in consumer prices in December basically reflected the increase in the prices of fresh food products (1.8 per cent) and the easing of the decline in energy prices, which since the summer have gradually incorporated the combined effect of a recovery in oil prices and the depreciation of the euro against the dollar. Excluding these factors,

inflation has remained contained. In December, the twelve-month change in the prices of non-energy industrial goods continued at the average pace observed in the second half of the year (0.4 per cent). The year-on-year increase in the prices of services was more pronounced (0.9 per cent, 0.4 percentage points higher than in November), attributable to price increases in transport services and, to a lesser extent, to recreational, cultural and personal care services. Overall, core inflation edged upwards (0.7 per cent in December, 0.5 tenths of a point higher than in September), reflecting the persistence of weak internal pressures related to the slow recovery in demand and substantial wage moderation.

In December, the share of items in the harmonized consumer price index (HICP) whose prices are still decreasing was 27 per cent, down 7 percentage points compared with November (Figure 15). The share of items whose prices rose by less than 0.5 per cent also declined (to 51 per cent, from 53 per cent in November), as did that of items with prices rising by less than 1 per cent (72 per cent, from 76 per cent in November). The proportion of elementary items whose prices are falling also decreased for the components of core inflation (25 per cent, down from 29 per cent in November).

Upstream of the retail segment, the downward trend in prices began to attenuate. The decline in the producer prices of industrial goods sold on the domestic market gradually weakened, decreasing by more than 1 percentage point in the second half of 2016 (-0.3 per cent in November, compared with -1.4 per cent in July). This process reflected the continuing decline in energy prices. The change in the prices of consumer goods produced for the domestic market turned positive again in October, after twelve consecutive months of contraction. The acceleration recorded in November (0.4 per cent) was driven by the rise in the prices of durable goods (which had been rising since the spring of 2016) and the upturn in the prices of non-durables.

Figure 15 – Proportion of goods and services experiencing deflation
(percentage share of elementary items of the HICP)



Source: based on Istat data.

The expectations of household and firms point to a rise in prices in the early months of the year. Consumer inflation expectations as reported in surveys showed a sharp rise in January, which more than offset the decline recorded in the final quarter of 2016 (the balance returned to -10, about 20 percentage points lower than the average in the fourth quarter). This improvement is attributable to the decline in the percentage of households expecting stable prices (49.2 per cent, 10 percentage points less than in December) and a rise in the proportion of consumers expecting prices to rise (39.1 per cent). Among businesses, manufacturing firms reported expectations of a moderate recovery in sales prices, particularly for intermediate and capital goods, while expectations for consumer goods showed a weakening of prices. Signs of a recovery in prices involved market services and, to a lesser extent, the construction and retail trade sectors.

Box – Effects of the downgrade of Italian sovereign debt on bank refinancing with the ECB

At the end of 2011, following the European sovereign debt crisis, the ECB put in place measures to reduce the constraints on refinancing, making loans to banks against the pledge of appropriate collateral represented by securities. The classes of financial assets accepted as collateral have been progressively expanded over the years of operation of the LTRO (Long Term Refinancing Operations) and TLTRO (Targeted Long Term Refinancing Operations). Currently, the ECB accepts as collateral not only government securities but also bank bonds (covered and uncovered) and corporate issues, bank loans, securitized assets (asset-backed securities), and the debt instruments of local and regional governments.

The Eurosystem Credit Assessment Framework is based on procedures, rules and techniques to determine the quality of the collateral offered to secure the requested loan. Specifically, the evaluation of creditworthiness is based on four pillars: i) external credit assessment institutions - ECAIs); ii) in-house credit assessment systems - ICASSs); iii) counterparties internal ratings-based – IRB – systems); and iv) third-party providers' rating tools - RTs).

Focusing on ECAIs, the ECB draws on the credit ratings issued by four international agencies: Standard & Poor's, Moody's, Fitch Ratings and DBRS. The conditions applied to loans granted by the ECB depend on the most favourable assessment of the four. Following the downgrade on 13 January 2017 of Italian government securities by DBRS, which lowered its rating from A-low (DBRS was the last agency assigning an A rating to the debt) to BBB-High, the credit quality of Italian sovereign debt (shown in bold in Table R1) has gone from medium-good to medium-low, as the other three agencies had already downgraded Italian debt in previous years.[2] The reasons for the downgrade by DBRS included the uncertainty about the country's ability to continue structural reforms, the weakness of the banking system and slow growth.

From the point of view of the ECB and on the basis of Guideline (EU) 2016/2299 of 2 November 2016 on the valuation haircuts applied to the implementation of the Eurosystem monetary policy framework, the downgrade increases of the difference (haircut) between the market value of the asset and the amount of credit that may be granted, which also varies as a function of the residual maturity and the coupon structure of the assets pledged as collateral (Table R2).

In the absence of any official quantification of the impact of the downgrade on the total credit that can be granted against existing collateral, an estimation can be performed using the following Bank of Italy information: i) the stock of collateral pool[3] assets pledged to the Eurosystem at the end of September 2016 amounted to about €186 billion; ii) the share of government securities in the collateral pool amounted to 32.5 per cent in September 2016; iii) the distribution by residual life of the securities used as collateral is equal to that of total government securities outstanding at October 2016, distinguishing between short-term assets (17.2 per cent), those maturing at between 1 and 5 years (36.1 per cent), those maturing at between 5 and 10 years (26.1 per cent) and those maturing at more than 10 years (20.7 per cent); and iv) the relative share by type of government security in December 2016 (BOTs: 6.8 per cent; BTPs: 90.4 per cent; CTZs: 2.8 per cent).

Together with the percentage haircuts given in Table R2, it is possible to quantify the need for additional collateral due to the downgrade. It would amount to about €4.7 billion, equal to 2.5 per cent of assets committed to the Eurosystem. Given that the pool of uncommitted but readily available

[2] The current rating assigned by DBRS is in line with the current assessment of Fitch Ratings (BBB+), which was set at level in March 2013 when the agency lowered its rating of Italian government securities from the previous rating of A-. The downgrade from "A" by Moody's and Standard & Poor's dates respectively to July 2012 (from A3 to Baa2) and January 2012 (from A to BBB+). The current rating from Standard & Poor's is that following subsequent revisions in July 2013 (BBB) and December 2014 (BBB-).

[3] The collateral pool is defined as the sum of assets actually pledged as collateral for refinancing and those not that are pledged but readily available. Added to unencumbered assets eligible for use as collateral, we obtain total eligible assets.

assets amounts to about €101 billion, the larger haircut applied following the downgrade represents, in aggregate, a modest share of the banks' liquidity needs.

Table R1 – Mapping of rating scales of Standard & Poor's, Moody's, Fitch Ratings and DBRS (1)

Decription of credit quality	Rating scale			
	Standard & Poor´s	Moody´s	Fitch Ratings	DBRS
Maximum	AAA	Aaa	AAA	AAA
Strong	AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-	AA High AA AA Low
Medium-good	A+ A A-	A1 A2 A3	A+ A A-	A High A A Low
Medium-low	BBB+ BBB **BBB-**	Baa1 **Baa2** Baa3	**BBB+** BBB BBB-	**BBB High** BBB BBB Low
Speculative	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-	BB High BB BB Low
Highly speculative	B+ B B-	B1 B2 B3	B+ B B-	B High B B Low
Considerable risk	CCC+ CCC CCC-	Caa Ca C	CCC	CCC CC C
Loss	D	.	DDD DD D	D

(1) Current rating of Italy shown in bold.

Table R2 – Haircuts applied on the basis of residual maturity in years and coupon structure of pledged securities
(percentages)

Residual life (in years)	Rating from AAA to A-		Rating from BBB+ to BBB-		Increase in haircut	
	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon	Fixed coupon	Zero coupon
[0-1)	0.5	0.5	6	6	5.5	5.5
[1-3)	1	2	7	8	6	6
[3-5)	1.5	2.5	9	10	7.5	7.5
[5-7)	2	3	10	11.5	8	8.5
[7-10)	3	4	11.5	13	8.5	9
[10-∞)	5	7	16	19	11	12

Source: based on ECB and European Union data.