Chapter 1: A tough transition for the Italian economy

The international economic cycle

1. Over the course of 2011 the international economy showed a marked slowdown compared with the previous year. Global GDP recorded growth of 3.9 per cent, as against 5.3 per cent in 2010, with the divergence between the economic cycles of the global economy's major areas accentuating. Weaker global output was reflected in a fall-off in trade of goods and services, growth in which is estimated at 5.8 per cent in 2011 (from 12.9 per cent in 2010).
2. Despite the slowdown in demand, dollar commodity prices continued to record strong increases: averaged over 2011, food commodities increased in price by 32.5 per cent, while industrial commodities rose by 16.7 per cent.
3. The growth rate in advanced economies halved, falling to 1.6 per cent in 2011 from 3.2 per cent the previous year, compared with a more moderate slowdown in emerging economies to 6.2 per cent from 7.5 per cent in 2010.
4. Over the course of 2011, the deteriorating international business cycle, high commodity prices and the negative impact of the sovereign debt crisis on households and firms were reflected in a loss of momentum in the economic recovery of the euro area. Cyclical dynamics deteriorated rapidly, exhibiting – after essentially stagnating for two quarters – a fourth-quarter fall in GDP in volume terms (-0.3 per cent); averaged over the year, the euro area recorded growth of 1.5 per cent.
5. Emerging economies continued to record sustained growth rates, but with different dynamics in the economic cycle. Specifically, in the latter part of 2011 and the first part of 2012, India, Korea, Russia and Poland have shown signs of strengthening, whereas Brazil and China have displayed a decelerating trend.
6. High oil prices, weak US recovery and ongoing tensions in financial markets related to the sovereign debt crisis are the main risk factors for the evolution of international growth.

A sharp slowdown for the Italian economy

7. Italian GDP recorded growth of 0.4 per cent in 2011 in volume terms (down from the previous year's 1.8 per cent). However, economic activity has not yet recovered to the level before the 2008-2009 crisis. The year saw weak growth in the first two quarters (+0.1 and +0.3 per cent respectively in quarter-on-quarter terms) and a contraction in the final two (-0.2 per cent in the third quarter and -0.7 per cent in the fourth).
8. Final consumption in volume terms showed no change averaged over 2011 (+0.7 per cent in 2010). General Government expenditure and expenditure by private non-profit institutions had a negative effect (-0.2 per cent) on GDP growth, while household expenditure contributed positively by one tenth of a percentage point. These trends are also influenced by the effect of corrective adjustments concerning disposable income and general Government expenditure.

9. In current values, disposable income increased by 2.0 per cent (+1.1 in 2010), while final consumption expenditure grew by 2.9 per cent (+2.7 per cent in 2010). As a result of the concurrent increase in prices, household purchasing power (i.e. households' disposable income in real terms) decreased by 0.6 per cent.

10. To compensate for decreased purchasing power, consumer households reduced their propensity to save (the ratio of household gross savings to disposable income) by 0.9 percentage points to 8.8 per cent, the lowest since 1990. In the final part of the year the propensity to save recorded a slight rise (to 9.1 per cent), causing an acceleration in the fall in consumption.

11. In 2011 gross fixed capital formation decreased by 1.9 per cent, negatively affecting growth by 0.4 percentage points. The decrease was particularly significant for investment in construction (-2.8 per cent) – the fourth consecutive year of decline – and in machinery and equipment (-1.5 per cent). Investment in means of transport, in contrast, grew (+1.5 per cent). Changes in inventories made a negative contribution to GDP growth (-0.5 percentage points).

12. Modest investment activity has been accompanied by increasing difficulties in accessing bank credit. The survey of business confidence in the manufacturing sector shows how, in the second half of 2011, firms' perception of credit terms has deteriorated sharply: the percentage of firms that have experienced tightening credit conditions – which rose almost continuously from mid-2010 – at the end of 2011 stood at between 35 and 45 per cent for all sectors: a very high figure, comparable to the one observed during the most severe phases of the autumn 2008 crisis. Deteriorating credit conditions have been compounded – with a slight delay – by an increase in the percentage of firms that perceive themselves as being effectively rationed, especially those whose loan applications have been turned down by banks.

13. Compared to prevailing conditions in March 2008, in the manufacturing and service sectors signs of a *credit crunch* have been emerging between late 2011 and the first quarter of 2012. From the analysis conducted, it seems that the "solidity" of firms plays a significant role in reducing the likelihood of credit requests being rejected, regardless of the size of the firm. However, the penalisation due to size is not fully offset by being in good economic health.

14. Of the demand components, net foreign demand made the largest contribution to GDP growth in 2011 (1.4 percentage points). In the context of a general slowdown in global demand, Italy's performance in foreign sales in 2011 (+6.3 per cent, as adjusted for days worked) was in line with the euro area average, for the first time since the single currency was introduced. In the same period, total imports showed only a moderate increase (+1 per cent), reflecting the sharp contraction in domestic demand.

15. In 2011 import-export trade recorded a much lower growth rate in value terms than the previous year: the slowdown was particularly pronounced for imports (+9.0 per cent, from +23.4 per cent in 2010), while it was less pronounced for exports (+11.4 per cent, from +15.6 per cent). Nevertheless, in 2011 both components completely recovered to 2008 levels.

16. The trade deficit fell to 24.6 billion euros in 2011 from 30 billion euros the previous year, albeit very high compared to pre-crisis levels. In particular, the deficit nearly doubled between 2008 and 2011, with an absolute difference of 11.6 billion euros.

17. Much of the deterioration in the trade balance between 2008 and 2011 was attributable to increased imports of intermediate and consumer goods. For the former this appears to be connected to greater demand for materials for export market production. For consumer goods the deterioration appears to be caused, on the one hand, by problems for Italian goods in recovering lost overseas market share, and on the other by growing absorption of imported goods by domestic demand.

18. During 2011, in keeping with the development of the international cycle, in terms of area export performance was better in non-EU market than the EU markets. The EU saw a significant fall in sales in virtually all of the major countries. With regard to markets outside the EU, lower export levels to the United States, the OPEC nations, China, Turkey, Russia and the Mercosur countries were partly offset by significant increases in exports to European countries outside the EU (+4.2 per cent), Switzerland, Japan and the ASEAN countries.

19. The system of Italian enterprises, which had not yet recovered from the losses suffered during the 2008-2009 crisis, experienced a new phase of difficulty in 2011 arising from contracting domestic demand coming on top of weakening foreign demand. The cyclical recovery in production from the lows of 2009 continued throughout the first half of 2011, subsequently recording a sharp reversal in the second half of the year.

20. Averaged over the year (net of calendar effects), the overall change in industrial production was almost nil: consumer goods (-3.1 per cent) and energy (-2.2 per cent) fell, while capital and intermediate goods, despite maintaining an upward trend, showed a sharp slowdown (+3.8 and +0.7 per cent respectively, compared with growth of 11.1 and 9.0 per cent in 2010).

21. The construction industry continued to contract, confirming a trend that has already been underway for several years. Value added recorded a fall of 3.5 per cent, higher than in 2010, similar to the trend in labour units (-3.1 per cent), while productivity declined further (-0.4 per cent), though to a lesser extent than in previous years.

22. The activities of the service sector, which had returned to growth in 2010 (+1.4 per cent), recorded a slowdown last year (+0.8 per cent).

23. The negative trend in consumption affected the retail sector, where turnover suffered a significant decline in value in 2011, despite the significant rise in prices: sales fell by 1.3 per cent. The difficulties of the commercial sector continued to penalise traditional retail (-1.4 per cent). However, sales in large-scale retail were down, too, by 0.9 per cent (from +0.7 per cent from 2010). The non-food component decreased by 1.8 per cent averaged over the year, while the change in the food component was zero.

24. Averaged over 2011, consumer price indices for the whole nation (NIC, intera collettività nazionale) have increased by 2.8 per cent, almost double the previous year. Italian inflation,

measured by the harmonised index and averaged over the year, was slightly higher than in the euro area countries (2.9 per cent and 2.7 per cent respectively).

25. Core inflation (measured net of energy and non-processed food items), although accelerating, was 2.1 per cent averaged over the year, with larger increases in sectors closely related to energy and food such as services for transportation and recreation and, and smaller increases for most industrial goods.

26. The overall index of producer prices of industrial products for the domestic market, which increased by 3.0 per cent in 2010, grew by 5.0 per cent in 2011. In addition to the energy goods sector, significant increases were also seen in the intermediate goods and food sectors.

27. The characteristics of the current inflationary episode, with increases concentrated in energy and food, have accentuated price increases for products purchased most frequently by consumers, in which the trend in 2011 remained higher than the inflation rate in 2011.

28. Based on national accounting estimates, employment, in terms of standard labour units, grew by 0.1 per cent in 2011 (23,000 labour units more than in 2010). The increase in volume of labour stemmed from a contraction of 0.7 per cent in self-employed labour, while employed labour recorded a growth of 0.4 per cent.

29. Based on the results of the Labour Force Survey, after two years of decline, in 2011 employment recorded an increase (+0.4 per cent, the equivalent of 95,000 extra units). Specifically, there was a marked increase of individuals in employment aged 50 and over (+254,000), a trend that can be attributed to increasingly stringent retirement requirements. In contrast, the number of those in employment among the younger age groups (a fall of 93,000 among those aged 15-29 and 66,000 for those aged 30-49). Female employment, after remaining stable in 2010, showed a positive trend (+110 ,000), which has influenced by the progressive increase in the retirement age for women in the public sector in order to bring it into line with that for men.

30. Growth in employment among foreigners (+170,000 units) continued, but the related specific rate of employment was, for the third consecutive year, in decline (from 63.1 per cent in 2010 to 62.3 per cent in 2011).The increase in male foreign employment was not able to offset the fall in employment among Italian men, which continued in 2011 (-95,000, or -0.8 per cent).

31. Averaged over the year, the effective number of hours of Cassa Integrazione Guadagni (CIG, temporary state layoff funds) decreased as a percentage of hours actually worked. Levels of use of this instrument are still higher than pre-crisis levels and the descent is completely attributable to lower use of this social safety net in the industrial sector (from 59.4 hours of CIG used for every thousand hours worked in 2010 to 46.6 hours in 2011), while in construction and services increases in the use of the CIG were observed.

32. In services, after the substantial stability of 2010, employment began to grow again (+151,000 units, or 1.0 per cent), depending on sector: the decrease in the number of individuals employed in commerce (-52,000, or -1.5 per cent) was offset by continued growth in household services (+106,000, or +19.4 per cent), four-fifths of which was accounted for by the foreign component.

33. The decrease in full-time, permanent employment continued (-105,000 units, or -0.6 per cent), while part-time, permanent employment grew (+63,000, or 2.3 per cent): this increase depended exclusively on workers who accepted a part-time job as they were unable to find a full-time one (from 42.7 per cent in 2010 to 46.8 per cent in 2011).

34. The number of fixed-term employment contracts and contracts for coordinated, continuative services increased (by 5.3 per cent to 136,000 units), concentrated mainly in employed positions. As was already the case in 2010, it was above all the number of short-term contracts which increased: the number of contracts with a duration of up to six months rose by 8.8 per cent (+83,000), while the number of those with a duration of over a year fell (-32,000).

35. The number of people seeking employment remained essentially unchanged from the previous year. However, in the first six months of the year there was a decrease (-264,000 compared with the same period the previous year, or -6.0 per cent), followed by an increase which took the total number of unemployed to 2.4 million in the fourth quarter (+249,000 units, or 11.4 per cent). The monthly unemployment rate began to increase again in the autumn of 2011, reaching 9.8 per cent in March 2012.

Public finances in Italy and Europe

36. Italy has continued the process of fiscal consolidation, recording an improvement in the net borrowing to GDP ratio of seven tenths of a percentage point (from -4.6 to -3.9 per cent). These advances were not enough to stem the trend in public debt, which stood at 120.1 per cent of GDP, up by 1.5 percentage points on 2010 and still well above the EMU and EU averages.

37. For Italy, the decreasing ratio of net borrowing to GDP was achieved thanks to a recovery in revenue, up 1.9 per cent, more than offsetting the 0.5 per cent increase in expenditure. In terms of impact on GDP, revenue grew by one tenth of one per cent, while expenditure showed a decline of 0.6 percentage points.

38. The increase in nominal terms of total revenue in 2011 (+1.9 per cent) was due to growth in both current and capital revenue. As regards the former, the increase in revenue was driven solely by the growth of indirect taxes (+2.0 per cent). Direct taxes, in contrast, suffered a decline, albeit a very small one (-0.1 per cent), mainly attributable to a reduction in income tax revenue due to changes in tax laws and regulations. The strong growth in the capital revenue component (+99.1 per cent) was mainly due to one-off payments of substitute tax on realignment with IAS international accounting principles.

39. Total expenditure grew by 0.5 per cent, although at a lower rate than the previous two years. Interest costs were sharply up in all EU countries: by 10 per cent in Italy, 9.3 per cent in Germany, 10.8 per cent in France, 28.6 per cent in Spain and 12.9 per cent in the United Kingdom.