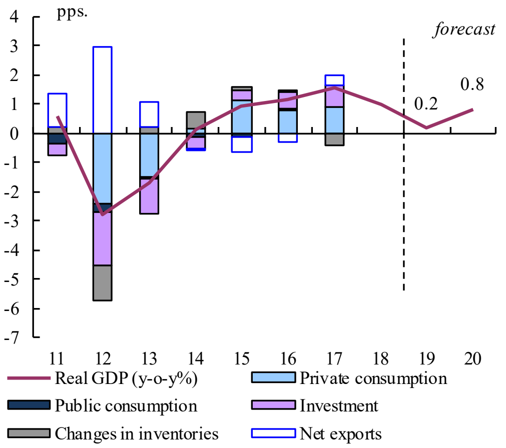
2.12. ITALY

Italy's economy started losing momentum in early 2018 amid a wider slowdown of the euro area and slipped into a contraction in the second half of the year. Real GDP fell by 0.2% in the last three months of 2018, following a 0.1% drop in the previous quarter. While the initial slowdown was largely due to less dynamic world trade, the recent slackening of economic activity is more attributable to sluggish domestic demand, particularly investment, as uncertainty related to the government's policy stance and rising financing costs took its toll. In annual terms, real GDP grew by 1.0% in 2018, helped by a sizable carry-over effect from the previous year. The ongoing weakening in the manufacturing sector with a further decline in economic sentiment bodes ill for the near-term outlook. Economic activity is likely to remain anaemic in the first half of 2019.

In 2019, annual real GDP growth is forecast to fall to 0.2%, sizeably less than anticipated in the autumn forecast. A worse-than-expected cyclical slowdown in 2018, amplified by global and domestic policy uncertainty and firms' substantially less favourable investment outlook, largely explain this downward revision. Moreover, the more marked slowdown of important trade partners is likely to have knock-on effects on Italian manufacturing output. Following the budget revision in December 2018, sovereign yields eased, but are still significantly higher than a year ago. In 2020, growth is expected to pick up to 0.8%, helped by a positive carry-over effect and two more working days in 2020. The forecast does not incorporate the effects of the rise in indirect taxes envisaged in the 2019 budget for 2020.

Graph 2.12: **Italy - Real GDP growth and contributions**



Private consumption is set to underpin GDP growth, helped by a rise in real disposable income due to lower oil prices and marginally supported by the introduction of the citizenship income scheme, but partly dampened by a deteriorating employment outlook. By contrast, business investment is expected to decelerate sharply in 2019 and remain muted in 2020. Following the setback recorded in the first half of 2018, exports recovered and are estimated to expand at a pace closer to that of foreign demand over the forecast period. As slowing investment is set to soften import growth, net exports are likely to provide marginal support to GDP growth. The growth outlook is subject to high uncertainty. A weaker-than-expected global economy and the impact of heightened policy uncertainty on sentiment and financing conditions of the private sector could lead to a more protracted downturn.

Headline inflation is forecast to moderate in 2019 on the back of lower energy prices. Consumer prices increased by 1.2% in 2018 but are expected to rise by only 1.0% this year, before picking up again to 1.3% in 2020. Core inflation is set to rise gradually over the forecast period, in line with wage growth.