# Italy: A soft growth patch vulnerable to inflation developments

Despite solid employment resilience, consumption looks set to decelerate in 2023. Still, together with investment, it should keep growth in positive territory

Giancarlo Giorgetti, Italian Minister for Finance

Source: Shutterstock

The jury is still out as to whether the Italian economy contracted in the fourth quarter of 2022, and we currently expect to see a minor -0.1% quarter-on-quarter fall in GDP. This year will likely see a soft start, followed by a gradual recovery over the rest of the year. The growth profile will be hugely affected by developments on the inflation front and their impact on both disposable income and domestic demand.

## Gradual inflation decline, with energy fall prevailing over core stickiness

The sharp decline in TTF natural gas prices seen over the past month (falling 60% to around 60€/MWh) should have a positive impact on the energy component of the inflation basket, creating room for positive base effects on headline inflation to unfold over the first months of 2023. The pass-through of energy price pressures is not over yet and will likely weigh on core inflation for some time.

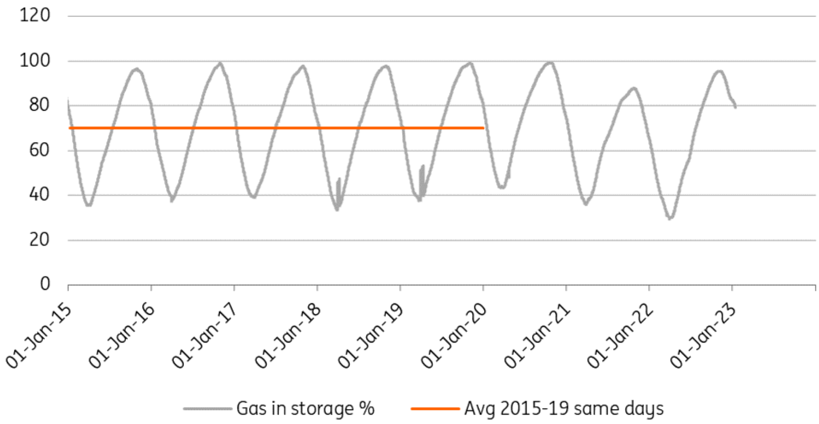
Signals from the business sector point to a decline in intentions to hike prices among manufacturers but not yet in services, suggesting that some form of reopening-induced consumption is still at work. Over the first half of the year, we expect the drop in energy inflation to outweigh the inertia in the core inflation component. This should induce a gradual decline in the headline index, which is expected to end the year above 2.5% year-on-year.

## Resilient employment should help limit the damage

Stubborn inflation is weighing on disposable income, but the effect is less noticeable than we had expected. In the third quarter of last year, real disposable income increased by 0.3% quarter-on-quarter despite accelerating inflation, mainly thanks to surprisingly strong labour market data. In November, against a backdrop of an economic slowdown, employment confirmed its peak at pre-pandemic levels. The unemployment rate, admittedly a backwards-looking indicator, was stuck at a multi-year low of 7.8%. High gas storage levels, which were just below 80% full by mid-January and resulted from unusually mild weather, further reduced the chance of energy rationing this winter and limited the scope for short-term supply shocks.

Still, with a modest deterioration in employment and shrinking room for substantial declines in the saving ratio (which fell to 7.1% in 3Q22, the lowest level since 4Q12 and below the pre-Covid average), we anticipate consumption will cool down over the 4Q22-1Q23 period. We then see it picking up at a moderate pace so long as inflation recedes. A short-lived and soft technical recession in the first quarter of 2023 remains our base case, but short-term upside risks are rising.

## Unusually high gas storage levels make energy rationing unlikely this winter




Source: AGSI+, ING Research

## Investment still growing

Private investment should also, in principle, remain a positive growth driver in 2023. This will build on two factors: a residual drive of residential construction investment fuelled by tax incentives, and the flow of new investments linked to the implementation of the national recovery and resilience plan (RRP). Both are exposed to downside risks, though. If residential construction suffers from the impact of rising interest rates, risks to the RRP front could emerge as the balance between reforms and investments shifts towards the latter. Further adding to the issue could be involvement from local administrations, which are less equipped to manage complex projects.

## Fiscal discipline: a valuable political capital for upcoming negotiations

The macro backdrop described above will fit into a prudent fiscal framework. The Meloni government crafted its 2023 budget with a piecemeal approach, in continuity with the Draghi government. Almost two-thirds of the €34bn budget is devoted to refinancing deficit measures designed to support (until 31 March 2023) households and businesses weathering the inflation shock. The rest is dispersed among other measures, ranging from refinancing the cut to the tax wedge (again, in continuity with the Draghi government) to extending a flat tax system for independent workers.

The government aims at a 4.8% deficit/GDP target for 2023, which implies a 1.1% reduction in the structural deficit. Fiscal discipline will be a valuable political capital to be spent in upcoming negotiations on reforming the stability and growth pact. In our view, risks to this for 2023 lie on the side of a slightly higher deficit but not enough to jeopardise another decline in the debt/GDP ratio. For the second year in a row, the inflation effect (through the GDP deflator) is set to work its magic on the debt ratio.

## The Italian economy in a nutshell (%YoY)

| | 2021 | 2022F | 2023F | 2024F |
|---|---|---|---|---|
| GDP | 6.7 | 3.9 | 0.5 | 1.4 |
| Private consumption | 5.1 | 4.8 | 1.8 | 1.2 |
| Investment | 16.5 | 9.7 | 2.5 | 1.9 |
| Government consumption | 1.5 | 0.3 | 0.0 | 0.4 |
| Net trade contribution | -0.1 | -1.0 | -1.0 | 0.1 |
| Headline CPI | 1.9 | 8.7 | 6.7 | 2.4 |
| Unemployment rate (%) | 9.5 | 8.1 | 8.1 | 8.2 |
| Budget balance as % of GDP | -7.2 | -5.4 | -4.8 | -3.7 |
| Government debt as % of GDP | 150.3 | 145.8 | 144.6 | 143.2 |

Source: Thomson Reuters, all forecasts ING estimates

### Author

**Paolo Pizzoli**
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

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