

# Italy: Soft start to 2022 on inflation headwinds

The inflation story will likely be a short-term drag on economic growth and put fiscal policy to the test

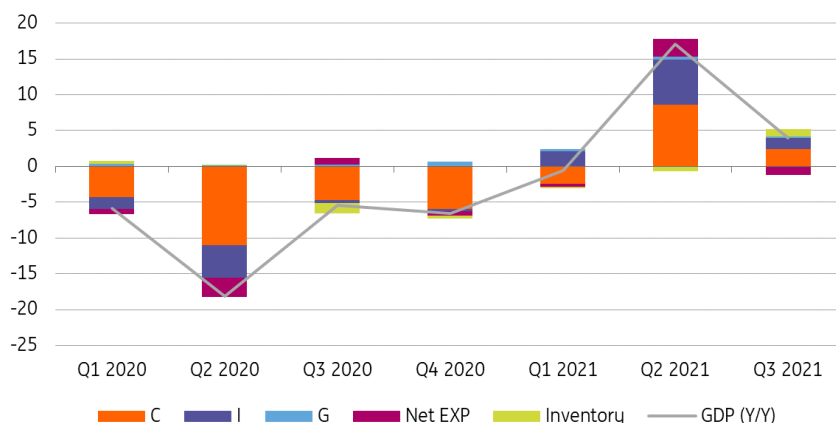


Italian President Sergio Mattarella was re-elected for a second term in January

## Strong rebound in 2021

Having contracted by 8.9% in 2020, the Italian economy rebounded by 6.5% in 2021, a good result after a soft start to the year. The estimated growth breakdown shows that this was almost fully ascribable to the recovery of private consumption and gross fixed capital formation. No magic wand, but the combined effect of a successful vaccination campaign, of broad-based reopenings which came with it, and generous public resources which helped to keep workers on payrolls and protect small businesses from liquidity shortfalls and bankruptcy.

## Domestic demand-driven rebound



Source: Refinitiv Datastream, ING

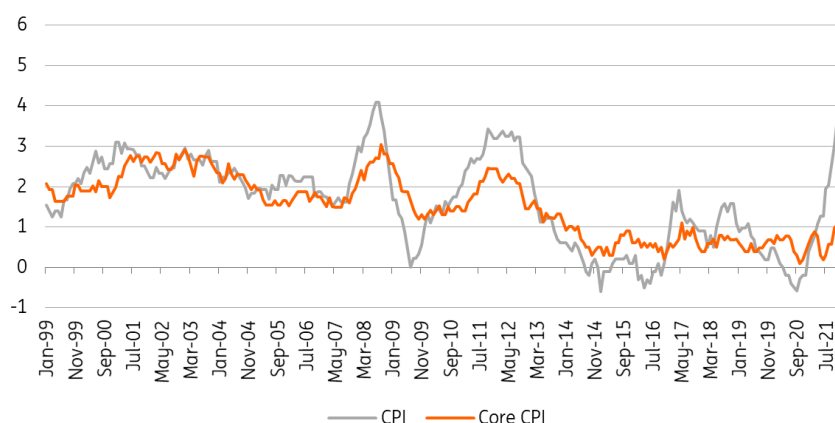
## Re-election of Mattarella to help Draghi refocus on the recovery plan over the rest of the legislature

After an almost inevitable slowdown in government activity in January in the run-up to the presidential election, a pressing schedule of targets and reforms foreseen by the Italian recovery plan will likely force an acceleration very soon. Under President Sergio Mattarella's renewed protective umbrella, Prime Minister Mario Draghi should now be in a better position to focus on execution until the end of the legislature, in spring 2023. True, the troubled electoral week opened cracks in the centre-right alliance and a leadership issue within the 5SM movement. However, we believe that in the short term this will not impact the government's stability, as the political price of deserting the alliance and creating a discontinuity in the inflow of EU money would be very high for any party.

## Fewer restrictions ahead, but inflation headwinds will likely slow down consumption in 1Q22

Tentative signs of regression in the Omicron wave have recently pushed the Italian government to announce an imminent reduction of restrictions, which is clearly good news for developments in the consumption of services. However, the positive impact on growth of a new wave of reopenings will have to face the strengthening headwind coming from inflation and its impact on real disposable incomes and business profitability. The acceleration of headline inflation to 4.8% year-on-year in January, mainly driven by the energy component, reflects Italy's vulnerability to gas price developments. To combat this and help low-income households and small businesses, the government has introduced extraordinary measures in the form of VAT cuts and bonuses on regulated energy bills. These notwithstanding, the average household is facing sharp price rises in energy bills. With wage growth at 1% year-on-year, the decline in January consumer confidence is hardly surprising and a deceleration in private consumption in 1Q22 seems highly likely.

## Inflation spike still mainly an energy story



Source: Refinitiv Datastream

## High energy prices could also affect production in early 2022

Businesses are not immune, either. Manufacturers, which are still dealing with persistently diminishing supply chain disruptions, are also confronted with high energy cost pressures and often remain hesitant to pass them through to consumers. Reports of possible temporary production stops among heavy energy users signal that industrial production could have a soft start in 2022.

## Design of fiscal compensation a first test for transition to “normal” fiscal discipline

The scope of the energy inflation issue has indirectly entered the political debate, with many parties already calling for quick parliamentary approval for a substantial pre-emptive extra deficit to get fiscal ammunition for more compensating measures should the inflationary wave last beyond 1Q22. For the time being, the government is banking on the fact that funds unspent in 2021 will likely be enough to finance extraordinary energy-related outlays over 1Q22. Should inflationary pressures persist in 2Q22, political requests for more spending would likely grow louder, and finance minister Daniele Franco would be forced to tread a thin line; on one hand trying to maintain political support, on the other, needing to migrate the country back towards a new normal of limited resources (call it fiscal discipline), at a time when negotiations on the reform of the Stability and Growth pact will likely be progressing, and the tapering of ECB net purchases will already be unfolding. The ongoing widening of the BTP-Bund spread suggests that markets are already watching closely.

	2022	2023F	2024F	2025F
GDP	3.9	0.7	0.4	1.0
Private consumption	5.0	1.5	0.5	1.0
Investment	10.0	1.5	-0.4	1.2
Government consumption	0.7	0.8	0.1	0.4
Net trade contribution	-0.5	-0.4	-0.5	0.3
Headline CPI	8.7	6.0	2.2	2.0
Unemployment rate (%)	8.1	7.7	7.8	7.7
Budget balance as % of GDP	-8.0	-5.4	-4.5	-3.7
Government debt as % of GDP	141.7	140.2	141.3	141.3

Source: Refinitiv Datastream, all forecasts ING estimates

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