Franco Bassanini

Overview of the Italian economic and financial situation (3 Q 2018)[1]

Global and European framework

Growth remains solid in the world, the main advanced economies included *(Fig. 1).* But world trade slowed significantly, and global risks have increased, as a result of financial tensions in many emerging economies and of the repercussions of the trade tensions sparked by the protectionist measures introduced or announced by the United States and of the retaliation from trading partners.

Economic activity in the euro area continues to expand. But the pace of growth in the Euro area remains lower than that of the emerging economies and shows some signs of a slowdown. Lastly, there is still considerable uncertainty over how economic relations between the United Kingdom and the European Union will evolve, after the UK's withdrawal from the EU.

Inflation remained at around 2.0 per cent in the third quarter, rising to 2.1 per cent in September *(Figure 2),* mainly driven by food and energy products *(Figure 3).* Core inflation is still low and, despite a slight recovery in pay growth in September, it remained stable at 0.9 per cent.
The ECB staff projections suggest that the increase in consumer prices will average 1.7 per cent this year.

ECB reduced its net asset purchases of sovereign bonds in October and confirmed its intention to cease them at the end of 2018. But reasserted the

[1] Revised text of a report held at the *Fifth Italian-French Dialogue on Financial Services*, organized by Paris Europlace and FeBAF (Italian Banking Insurance and Finance Federation), Paris, November 13th 2018 .

need to maintain an ample degree of monetary accommodation as long as necessary.

Italy: the economic and financial situation

GDP

In the third quarter of 2018, after fourteen consecutive increases, Italian GDP remained flat (+0.0%) *(Fig. 4).* It increased by 0.8 percent year over year. The carry-over annual GDP growth for 2018 is 1.0% *(Fig.5).*

This result is due to both domestic demand and net export null contribution A deterioration in the manufacturing (-0.3% in September), confirmed weak industrial production figures in the period June-August *(Fig. 6).*

Over the same quarter, foreign markets sales showed greater dynamism than those on domestic markets (respectively +1.6% and +0.2%), different dynamic confirmed by the industrial new orders (- 0.7% and +2.4% respectively).

Export

In the second quarter of 2018, Italian exports stalled, reflecting weak world trade, but recently improved *(Fig. 7).*

Based on the cyclical indicators, the outlook is still uncertain. In the first nine months of the year, exports towards non-EU countries fell in sales volume, despite the increase in unit values, while opposite trends have been observed in the case of the United States. Among the European Union countries, there was a rise in sales to France, Germany and Poland, reflecting increases in both unit values and volumes *(Fig. 8).*

Despite the slowdown in global trade, the current account surplus remained ample, having reached 2.8 per cent of GDP *(Fig. 9).*

Italy’s net international debtor position continued to decline, falling to 3.4 per cent of GDP at the end of June *(Fig. 10).*

Purchases of Italian portfolio securities by foreign investors in the early part of the year were followed by net sales between May and August, though with considerable fluctuations.

Economic sentiment

Confidence indicators for the service sector, households and manufacturing firms were still favourable *(Fig. 11)*.

In October, the consumer confidence slightly increased supported by improvements in the personal conditions and future expectations *(Fig. 12)*.

In the same month the composite business confidence index showed a slight decline diffused to all economic sectors but construction. Manufacturing firms' confidence worsened over the summer, as international trade tensions intensified *(Fig. 13)*.

Investment will continue to expand overall in 2018, albeit less than planned at the beginning of the year *(Fig. 14)*.

The Istat (National Institute of Statistics) leading indicator decreased further, suggesting that the economic activity will continue to moderate in the coming months *(Fig. 15)*.

Labour market

The recovery in the labour market continued. Employment rose considerably in the spring. Unemployment fell to 9.7 per cent in August, decreasing significantly for young people too (*Fig. 16)*.

In Q3, the labor market showed a slightly positive trend with an increase in the employment rate (+0.1 percentage points compared to the previous quarter) and a decrease in the unemployment rate (-0.6 p.p.) (*Fig. 17)*.

The growth in contractual wages, which had been showing signs of recovery since the end of 2017, strengthened in the private sector and in the economy as a whole, extending to actual wages as well. (*Fig. 18).*

Prices

In October, inflation showed an upward trend. According to the preliminary estimate the consumer price index (NIC) increased by 1.6% y-o-y with a recovery of two percentage points compared to previous month (*Fig. 19).*

Inflation rate was affected by exogenous shocks, particularly by the sharp recovery of energy prices driven by higher oil prices.

Core inflation showed lower figure (+0.8% y-o-y), The price dynamics continued to fall below the euro area average (+2.2%).

Household debt

In the second quarter of 2018, the ratio of Italian household debt to disposable income increased to 61.4 per cent (from 61.1 per cent in March; well below the euro-area average of 94.9 per cent *(Fig. 20).*

As a share of GDP, household debt grew from 40.8 to 41.1 per cent (57.8 in the euro area).

Profit share and investment rate

As for Non-financial corporations, the profit share and the investment rate remain stable and sound *(Fig. 21).*

The gross profit share of Non-financial corporations was 42.2% in the 2nd Q 2108 compared to 42.3% in the 1st Q.

The gross investment rate grew from 21.0% in the 2nd Q 2017 to 21.9% in the 2nd Q 2018.

Loans

Loans to households and firms grew moderately, supported by a small growth in demand *(Fig. 22)*.

The average interest rate on new loans to firms was still very low by historical standards *(Fig. 23)*, although a slight increase in September and October 2018.

Credit quality has improved steadily: net of loan loss provisions, the ratio of non-performing loans to total outstanding loans fell further to 4.7 % in the second quarter, close to pre-crisis level *(Fig. 24)*.

The stock of bad loans fell down to 40 bn from 89 bn of the pick touched in 2015 *(Fig. 25).*

Banks

The earnings and capital conditions of banks have improved significantly since the beginning of the year. But share prices in the banking sector, which grew at a faster pace than in the other euro-area countries between January and April, were affected by the uncertainties on the Italian financial market that emerged in mid-May.

In June the common equity tier 1 (CET1) of the significant banks was equal to 12.7 per cent of risk-weighted assets *(Fig. 27).* On an annual basis, the CET1 ratio grew; but compared with the first quarter of 2018, it was down by about 50 basis points.

This trend reflected both the increase in risk weighted assets and the reduction in capital. The latter was due in part to the decrease in the value of provisions which, in turn, was affected by the decline in the prices of government securities held in bank portfolios, which contrasted with the positive contribution of profitability *(Fig. 28).*

The yield on bank bonds in the secondary market and the premiums on bank credit default swaps fluctuated widely in connection with the movements in the sovereign risk premium.

In mid-October, bank share prices were down 16.2 per cent from the end of the second quarter (28.1 per cent from the end of the first).

The CDS premiums of the main Italian banks stand about 110 and 40 basis points higher than at the end of the first and second quarter respectively.

Financial markets

The Italian financial markets have been affected by strong tensions as a result of investors' uncertainty about the economic policy stance *(Fig. 29)*.

Government bond yields have increased, including those on shorter maturities. The spread between Italian and German bonds was around 300 basis points in mid-October *(Fig. 30)*.

The sovereign risk premium grew, and the price of CDS for Italy has considerably increased, after having fluctuated considerably *(Fig. 31)*.

Italy: Public Finance and Political framework

Economic policy stance: continuity or turnaround?

As I have emphasized many times in our past meetings, Italy has, in my view, fifth major structural problems:

- the political and regulatory instability;
- the very low birth rate and the aging of the population,
- a high unemployment rate especially among young people and in the South and a significant number of families living in absolute poverty
- the stagnant total factor productivity,

and, of course,

- the high public debt.

The last three were worsened in the last decade by the strong decline in public and private investment.

In the last 2/3 years, however, two significant trend reversals have taken place, even if they are still insufficient to place the country on a safe path of growth, job and fiscal consolidation:

- a strong recovery in private investment in the export-oriented manufacturing sector (also thanks to a set of government measures such as the basket of incentives known as Industry 4.0); and
- a budgetary policy aimed at reconciling fiscal discipline and support for growth, able to encourage the recovery of private investment but also to stop the growth of public debt, through a substantial and permanent primary budget surplus *(Fig. 32)*.

It is not yet clear if the new Italian government expressed by the March elections will or will not continue these policies and, eventually, in what ways and with which instruments.

In the meantime, uncertainty is itself a risk factor and a disincentive to investments.

Public finance: the starting point: 2017-2018

Let's begin by public finance.

In 2017, the deficit was -2.4% of GDP (vis-à-vis the target of -2.1% of GDP planned in the Update to 2017 EFD), due to the impact of measures to support the banking sector (which were worth 0.4% of GDP) *(Fig. 33).*

For 2018, the nominal deficit in the first half of the year was in line if not better than the one projected by the 2018 Stability Program in April. The deficit outturn for this year is estimated at 1.8% of GDP. The structural balance in 2018 will be -0.9% of GDP, with a 0.2 percentage point improvement vis-à-vis 2017.

The debt-to-GDP ratio recorded a moderate but constant reduction from a 2014 high of 131.8%, to 131.6% in 2015, 131.4% in 2016 and 131.2% in 2017. It is projected to decline to 130.9% in 2018.

The EU Commission Country Specific Recommendations for Italy

In the EU Commission view[2], with the Budget law for 2019, Italy should (*Fig. 34)*:

- ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP*;*
- use windfall gains to accelerate the reduction of the general government debt ratio;
- shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values;
- step up efforts to tackle the shadow economy;
- reduce the share of old-age pensions in public spending to create space for other social spending;
- ensure enforcement of the new framework for publicly-owned enterprises and increase the efficiency and quality of local public services;
- address restrictions to competition, including in services, also through a new annual competition law;
- step up implementation of the reform of active labour market policies to ensure equal access to effective job-search assistance and training *(Fig. 35)*;
- implement the insolvency reform and improve market-based access to finance for firms;
- foster research, innovation, digital skills and infrastructure through better-targeted investment.

[2]European Commission, *Recommendation for a Council Recommendation on the 2018 National Reform Programme of Italy and delivering a Council opinion on the 2018 Stability Programme*, Brussels, May 23rd 2018.

The Draft Budgetary Plan 2019

Starting from a baseline deficit of 1.2 % of GDP in 2019, 0.7 % in 2020 and 0.5 in 2021, the Draft Budgetary Plan 2019 (DBP) will target a deficit of 2.4 % of GDP in 2019 and provides then a gradual decrease of deficit to 2.1 % in 2020 and 1.8 in 2021, when the deficit/GDP ratio will reach the same level expected for the current year *(Fig. 36)*.

As to net structural borrowing, the DPB indicates an increase of 0.8 percentage points of GDP, bringing it to 1.7 per cent in 2019, in 2020 and in 2021. Following an estimated improvement of 0.2 percentage points this year, the structural balance would therefore worsen by 0.8 points in 2019.

Fiscal consolidation would resume in 2022; but it would be brought forward only if GDP and employment were to return to pre-crisis levels before 2021.

The attainment of a structural budget balance, which in the current legislation scenario was expected to be virtually achieved in 2020, would be postponed to 2023 or even 2024.

Regarding the debt-to-GDP ratio, the Draft Budgetary Plan envisages further privatization or alternative revenue earmarked to the public debt amortization Fund worth 0.3 per cent of GDP in 2018- 2020. Taking also into account these revenues, the general government debt ratio is expected to decline by 0.9 per cent of GDP in 2019, 1.9 in 2020 and 1.3 in 2021. Therefore, the debt ratio will decline, from 131.2 per cent in 2017, to 126.7 in 2021, 123,8 net of financial support given to other Euro area countries.

Italian Government vs European Commission on budgetary targets and macroeconomic effects of the DPB

These new budget targets alter significantly the path of fiscal consolidation for the next three years compliant to the EU Stability Program and suggested by the EU Commission Country Specific Recommendations for Italy**.**

Also, the Italian Government's macroeconomic forecasts, under the DPB policy scenario, envisage significant differences compared to consensus and to the EU Commission forecasts *(Fig. 37)*.

In Government's view, a more supportive fiscal stance and a different composition of the budget will lead to an important increase of the growth ratio and a consequent decrease of debt/GDP ratio *(Fig. 38)*. Real GDP is expected by the Government to grow by 1.5 % in 2019, 1.6% in 2020 and 1.4% in 2021.

Real GDP growth should be led by domestic demand and a recovery in exports. Household consumption (which is projected to grow by 1.1 % this year, down from 1.5 percent in 2017) will pick up to 1.3 % in 2019 and 1.6 % in the two following years, thanks to an expansion in labor income and increased social transfers. Compared with the baseline scenario, households' purchasing power will also be supported by the repeal of indirect tax hikes‒complete in 2019 and partial in 2020 and 2021.

On the whole, the forecast envisages a further rise in the investment-to-GDP ratio, although the latter will remain below pre-crisis levels (*Fig. 39)*.

Should additional fiscal space materialize as a result of higher-than-expected GDP growth or of lower interest payments on public debt, the DPB provides that this space will be used to step up public investment and incentives on private investment, while the EU Country Specific Recommendations for Italy (CSRs) suggested to "use windfall gains to accelerate the reduction of the general government debt ratio".

The Italian Government's Reform Agenda

The main measures envisaged by the Budget Law (BL 2019) and included in the National Reform program are *(Fig. 40)*:

- the total sterilization of the safeguard clauses (VAT increases) for 2019 and the reduction of those expected for 2020 and 2021,
- the relaunch of public and private investments,
- the introduction of the flat tax with a low rate
- the establishment of a Citizens basic Income, and
- a reform of the pension system

For the relaunch of public investment the BL 2019 allocates additional resources and introduce organizational and regulatory improvements. New resources are allocated to the extraordinary maintenance program of the road network that the Government has set up after the collapse of the Morandi bridge in Genoa. A central command cabin and a special technical task force will be set up to help public administrations and especially local institutions to develop and structure good infrastructure projects.

A flat tax with a low rate (15%) will be provided, but, for the moment, only for low revenues small businesses and for low income self-employed workers,

For the strengthening of the fight against poverty and unemployment, a Citizen Basic Income will be introduced, aimed at supporting those who are below the poverty line. The reform should, at the same time, favor their reintegration into the labor market through a binding training path, managed by appropriately reformed and restructured public job-placement centers.

Italian Government vs European Commission on Reform agenda

The Italian Government Reform agenda converges on some issues with the EU Commission CSRs but diverges on other non-secondary ones.

The main ground for dissent is obviously the financial maneuver, which the EU Commission has asked to change substantially, threatening otherwise the opening against Italy of an Excessive Deficit Procedure (for the first time due to excess of debt).

Among the other reforms (or measures) not compliant with the EU Commission’s CSRs, I must remember at least:

- The set of rules revising the pension system. Following the DPB, the age of retirement, which is today among the highest in Europe by virtue of the so-called Fornero Law, could be anticipated using a clause called "quota 100", defined as the sum of the age reached (62 years) and the years of contributions to social security (minimum 38 years). In the declared intentions of the Government, the reform is aimed to facilitate generational turnover and to enable young people to enter the labor market. Of course, it could reduce (if not offset by reductions in the amount of pension benefits) the long-term financial sustainability of the Italian pension system, while the CSRs asked to “reduce the share of old-age pensions in public spending to create space for other social spending”
- A revision of the labor market reform (provided by the so-called Dignity Act) introducing a substantial reduction in flexibility rules set by the so-called Jobs Act, while the CSRs asked to step up the implementation or the previous active labor market policies
- A (limited) amnesty for tax payers not compliant with the payment of taxes. The decree law on "fiscal peace" provided a simplified definition of taxpayers' debts and the closing of pending litigation, a five years period payment in installments and a reduced interest rate for tax debts.
- A postponement in the implementation of the reform of publicly-owned public utilities enterprises, which the CSRs suggested on the contrary to accelerate.

How will it end?

In my view the success of the Government reform agenda and the sustainability of the budget maneuver for 2019-2021 **depends on the outcome of four bets.**

The first is that the measures envisaged prove to be able to boost Italian output, that is to determine in fact a strong acceleration of the rate of growth (increase in nominal GDP compared to forecasts).

This seems rather unlikely to most pundits and analysts, who have emphasized that the Italian Government measures consist mainly in increase of current expenditures and that the provided acceleration of public investments will encounter many regulatory, bureaucratic and organizational obstacles, very difficult to remove quickly[3].
The Bank of Italy, on the other hand, does not exclude that the impact on growth of the Government's measures could be significant, but underlines that "their effects will depend on the design, timing and implementation of the reforms"[4], which are not yet known.

The second bet is on the cost of the envisaged reforms and measures. The Budget Law estimates that all the new measures listed above will, at the end of the day, involve total financial charges not exceeding 0,5% of GDP. But this seems possible only if we assume that they will be only partially implemented, something which could, on the one hand, trigger reactions and protests with negative effects on the consent to the Government, and, on the other hand, would reduce the impact of the maneuver on growth and employment.
In any case, the Government has very recently announced its intention to introduce safeguard clauses aimed to make automatic corrections in case of higher expenses compared to the budget forecasts.

The third bet is that the deviation from the fiscal consolidation path followed in recent years and the consequent violation of the rules of the European Stability and Growth Pact do not trigger too negative reactions from the European Commission, the European Central Bank, the financial markets and the agencies rating.
However, the European Commission has already requested a radical change in the maneuver and threatens the opening of a procedure for excessive debt; the main rating agencies have reduced the Italian sovereign

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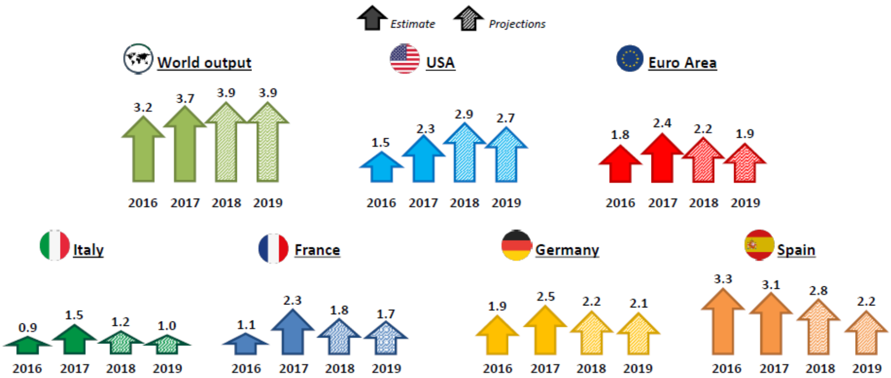
[3] See for ex. Olivier BLANCHARD and Jeromin ZETTELMEYER, *The Italian Budget: A Case of Contractionary Fiscal Expansion?* Peterson Institute for International Economics, Washington, October 25th 2018. Blanchard and Zettelmeyer think that "*the planned fiscal expansion will probable fail to increase growth – and may even reduce it*" and that Italy may have to face "*the challenge of weathering a growth slowdown whose seeds were planted in large part by this year's expansionary budget*".
[4] Bank of Italy, *Economic Bulletin,* Oct. 2018, p.40.

rating to a level just above that of the rubbish bonds (BBB for S&P and Fitch, with negative outlook, Baa3 for Moody's, with stable outlook); and, much more important, the markets have raised the risk premium for Italian sovereign debt with a spread almost 300 basis points higher than the German debt (something which, following past evidences, will have negative effects on bank funding rates and bank lending rates).
In order to keep open the negotiation with the EU Commission and to mitigate the reactions of the markets, the Government has very recently proposed an extension of the public assets' privatization plan from 0.3% to 1.0% of GDP and the inclusion in the budget law of automatic safeguard clauses aimed to avoid a possible increase in the deficit beyond the expected threshold. The Government therefore seems to be aware that, in the end, as Bank of Italy points out, "the effectiveness of the budgetary policies in supporting the economy will also rely on the preservation of saver and investor confidence in the attainment of balanced public finances"[5]: this is, in fact, the main challenge the Italian Government must overcome.

The fourth bet is the stability of the political framework and the holding of the parliamentary majority.
On this point it is very difficult to make predictions, if we consider that the two political forces that made up the majority have different cultures, ideologies and programs and, moreover, represent different constituencies.
Significantly, they did not build a common program, but they negotiated and signed a "Government contract", in which each of the two political components of the majority obtained the inclusion of the reforms considered by him as fundamental and indispensable, in exchange for the insertion of reforms deemed fundamental and indispensable by the other.
For now, the contract has held. In the future we will see.

[5] Bank of Italy, *Economic Bulletin*, Oct. 2018, *ibidem*.

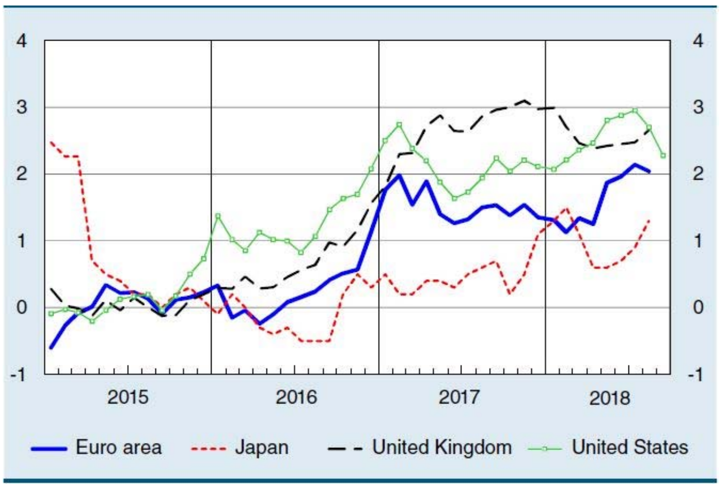
Real GDP growth: prospects and forecasts



Note: annual percent change
Souce: IMF – World Economic Outlook Update, July 2018

Consumer price inflation in the main advanced economies (1)

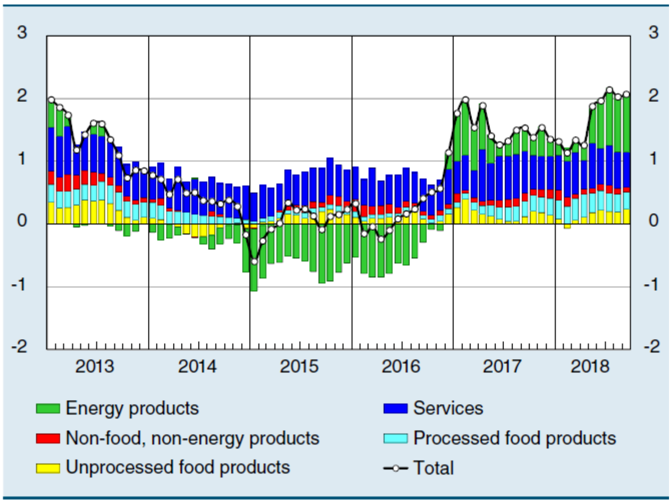
(monthly data; 12-month percentage changes)



Source: Thomson Reuters Datastream.
(1) For the euro area and the United Kingdom, harmonized consumer prices.

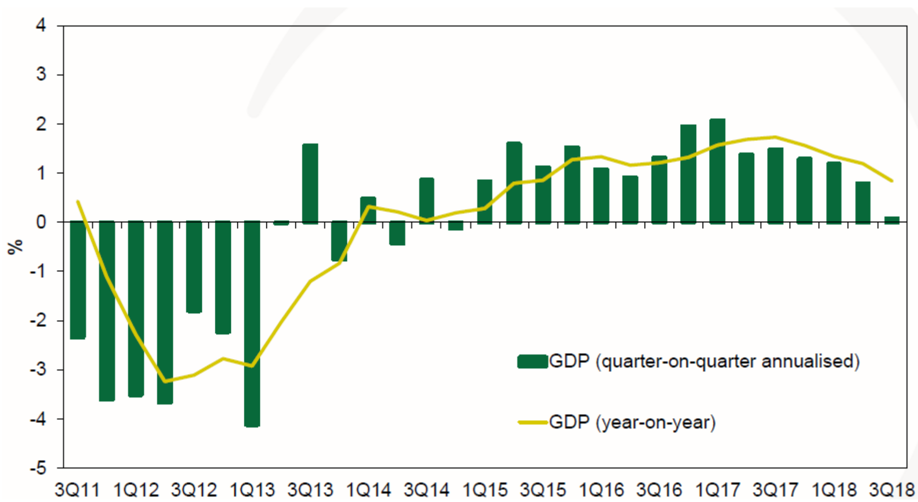
Euro-area inflation and contributions of its components (1)

(monthly data; 12-month percentage changes and percentage points)



Sources: Based on Eurostat and ECB data.
(1) Harmonized index of consumer prices.

Italy's recovery continues, but with reduced momentum



Source: ISTAT

III quarter2018 -GDP Preliminary Estimate

TABLE 1. GROSS DOMESTIC PRODUCT, CHAIN LINKED VALUES, QUARTER ON PREVIOUS QUARTER AND ON SAME QUARTER A YEAR AGO PERCENT CHANGES

1st quarter 2014 – 3rd quarter 2018 (a), seasonally and calendar adjusted chain linked values in millions of euro (reference year 2010)

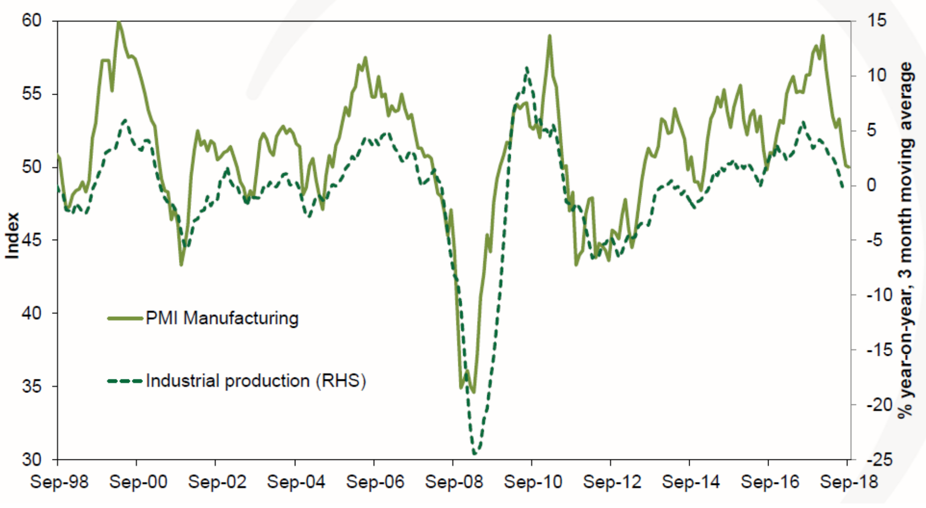
Quarter	Millions of Euro (chain-linked)	Quarter on previous quarter	Quarter on same quarter a year ago
2014 - I	385,867	+0.1	+0.3
2014 - II	385,447	-0.1	+0.2
2014 - III	386,278	+0.2	0.0
2014 - IV	386,151	0.0	+0.2
2015 - I	386,959	+0.2	+0.3
2015 - II	388,500	+0.4	+0.8
2015 - III	389,582	+0.3	+0.9
2015 - IV	391,069	+0.4	+1.3
2016 - I	392,125	+0.3	+1.3
2016 - II	393,021	+0.2	+1.2
2016 - III	394,305	+0.3	+1.2
2016 - IV	396,232	+0.5	+1.3
2017 - I	398,285	+0.5	+1.6
2017 - II	399,650	+0.3	+1.7
2017 - III	401,136	+0.4	+1.7
2017 - IV	402,429	+0.3	+1.6
2018 - I	403,625	+0.3	+1.3
2018 - II	404,423	+0.2	+1.2
2018 - III	404,509	0.0	+0.8

(a) Data are provisional and subject to revisions.

Source: ISTAT, Preliminary Estimate of GDP, 30 October 2018

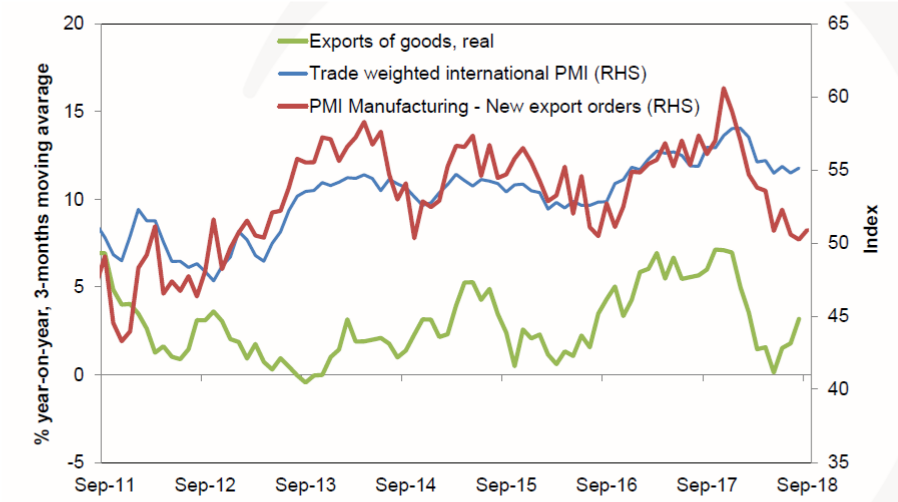
- In the third quarter of 2018 the seasonally and calendar adjusted, chained volume estimate of Gross Domestic Product (GDP) was unchanged with respect to the previous quarter and increased by 0.8 per cent year-over-year.
- The quarter on quarter change is the result of an increase of value added in agriculture, forestry and fishing and in services and a decrease in industry. From the demand side, there is a null contribution by both the domestic component (gross of change in inventories) and the net export component. The carry-over annual GDP growth for 2018 is equal to 1.0%.

Manufacturing PMI consistent with slow production growth



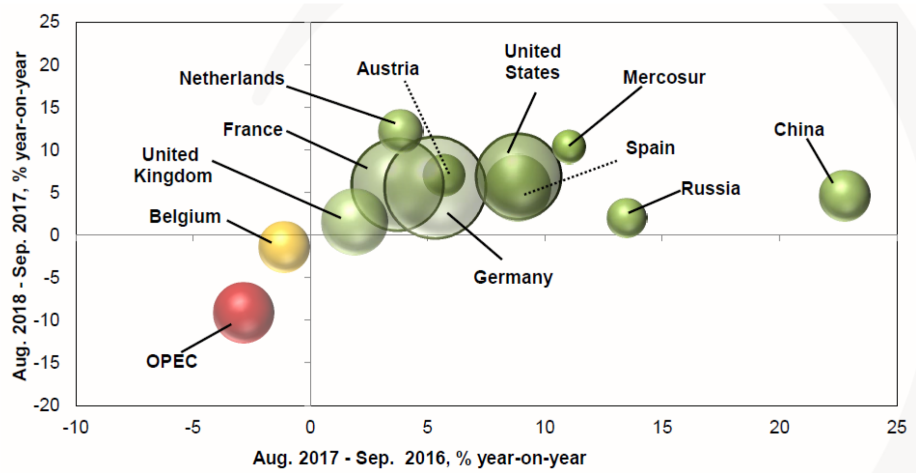
Source: IHS Markit, ISTAT

Exports fell in early 2018, but recently improved



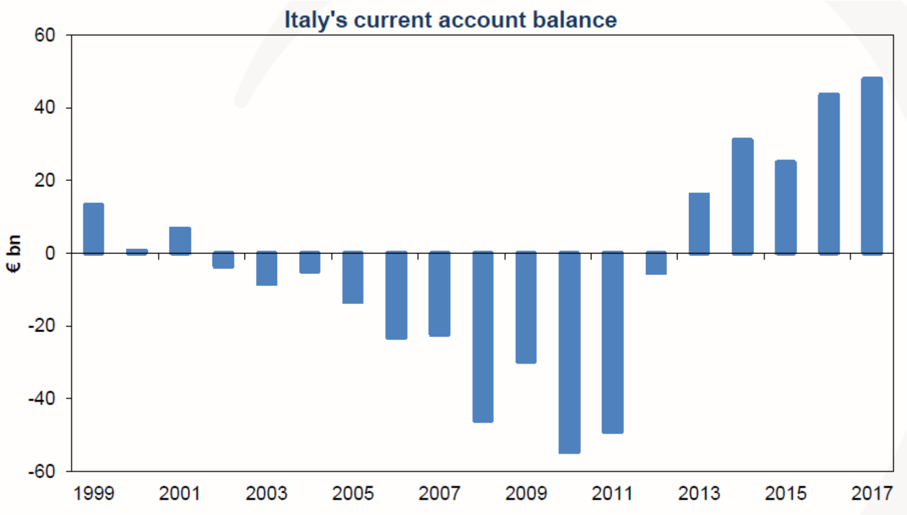
Source: MEF calculation based on ISTAT and MARKIT data

Exports more dynamic towards China, EU and US



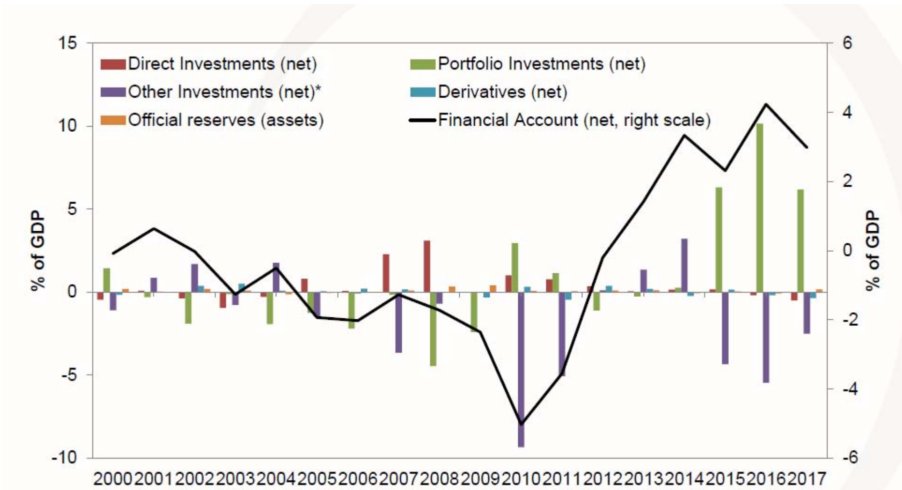
Note: The green bubbles represent countries towards Italian exports rose in the range 1.6/13 per cent over the 12 months until August 2018; the yellow one indicates country where the decrease is below 2 per cent; for the red one, the decline is around -9 per cent. The size of globes represents the share of a country on Italian exports.
Source: ISTAT

Current account surplus set to remain large



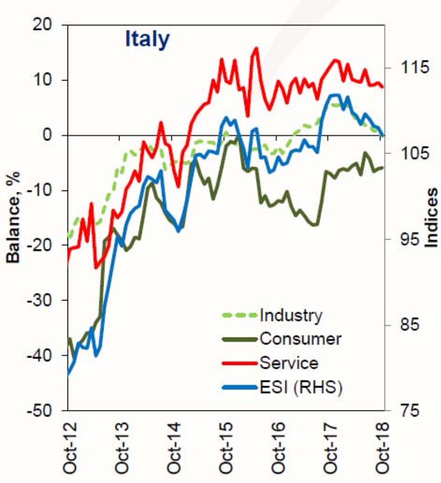
Source: Bank of Italy

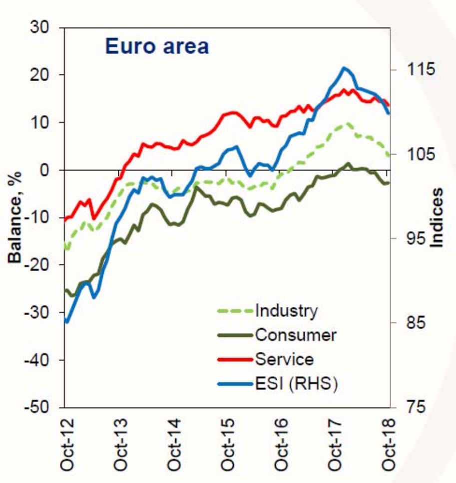
Net international investment position maintains positive momentum



(*) Data inlcude Target 2. Source: Bank of Italy
Source: Bank of Italy

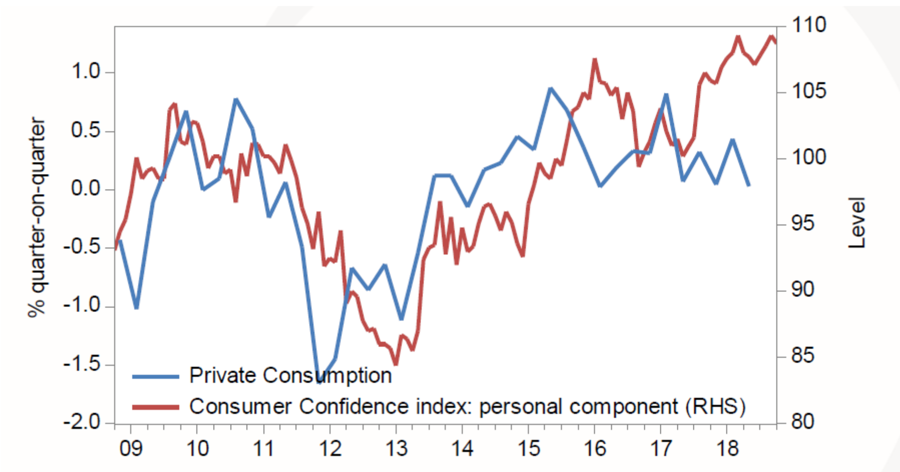
Economic sentiment index points to moderation of expansion





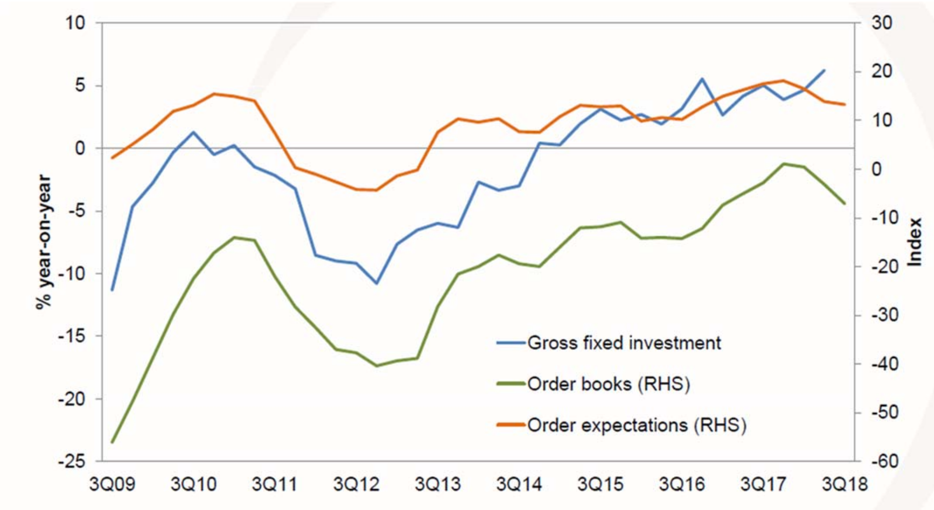
Source: European Commission

Consumers remain optimistic



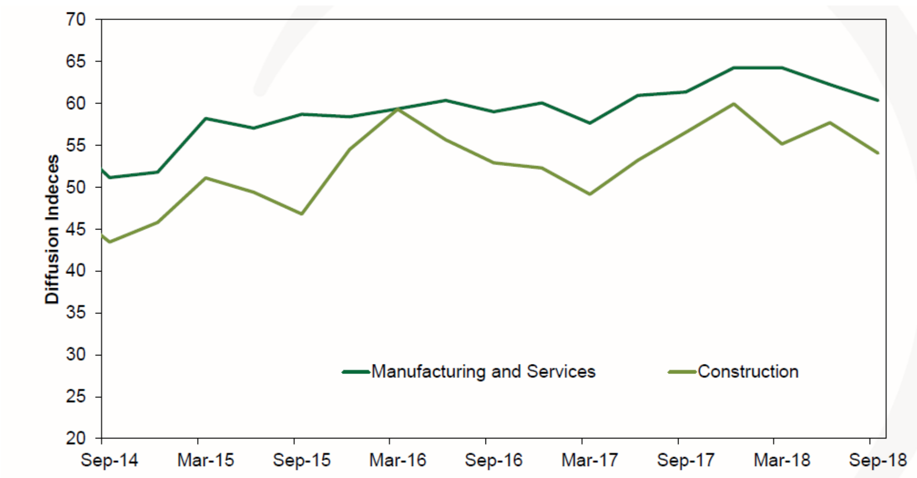
Source: Istat

Capital goods producers less upbeat about the outlook…



Source: Istat

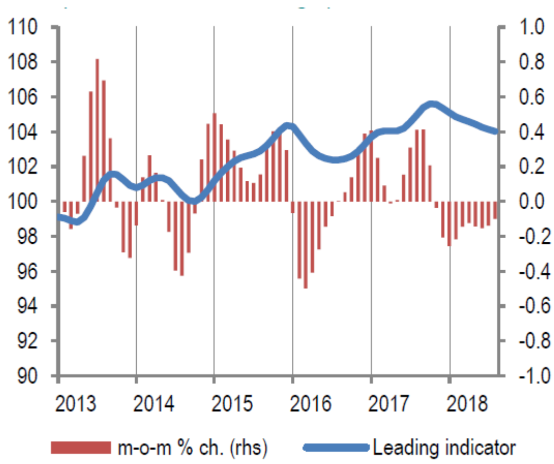
…though firms' investment plans still point to expansion



Source: Bank of Italy,Survey on Inflation and Growth Expectations (3Q - 2018), October 2018

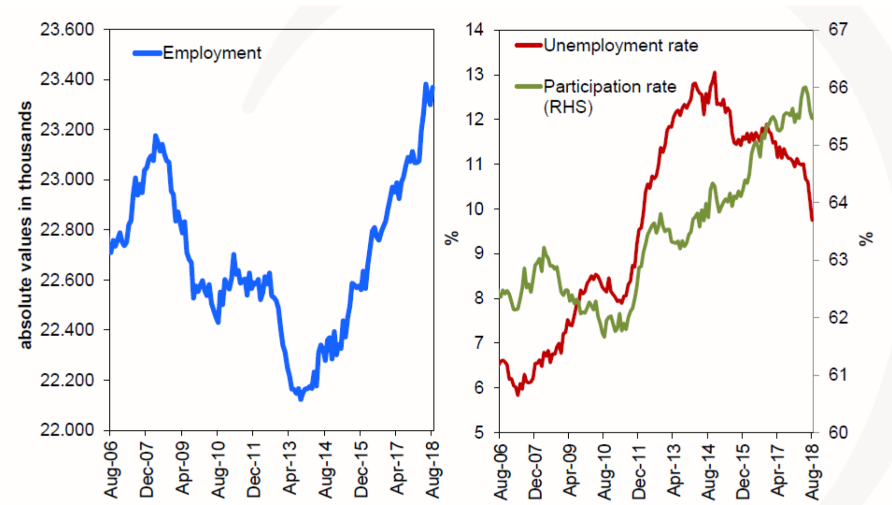
Leading indicator

(index and % change)



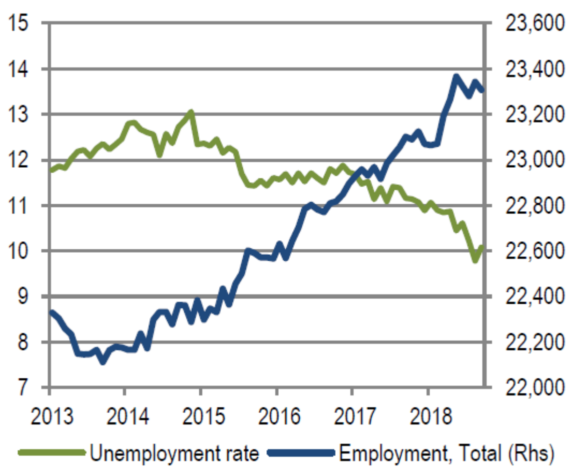
Source: Istat

Job growth holding up as unemployment rate falls



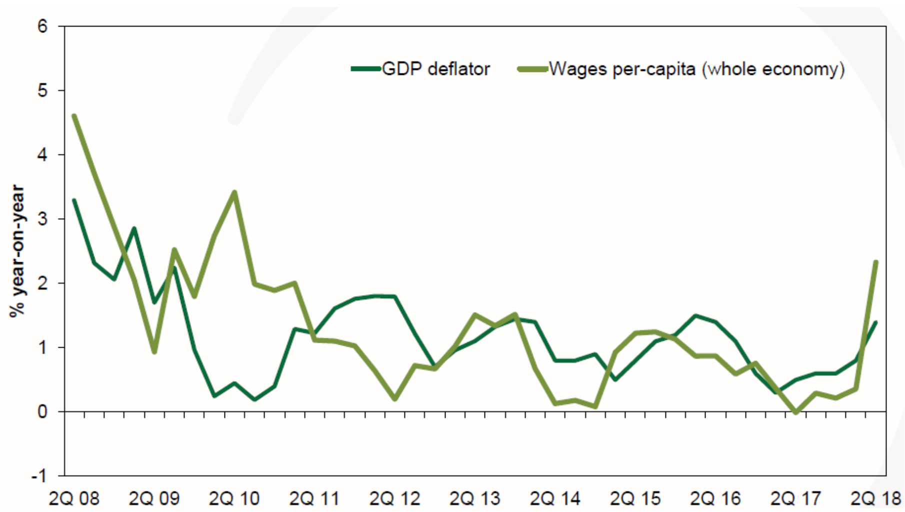
Source: Istat

Employment and unemployment
(thousand and %)



Source: Istat

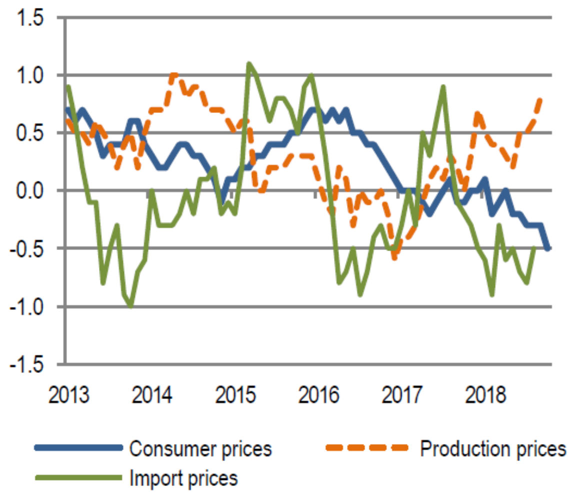
GDP deflator accelerated in Q2, as wages picked up



Source: Istat

Industrial producer prices excl. energy

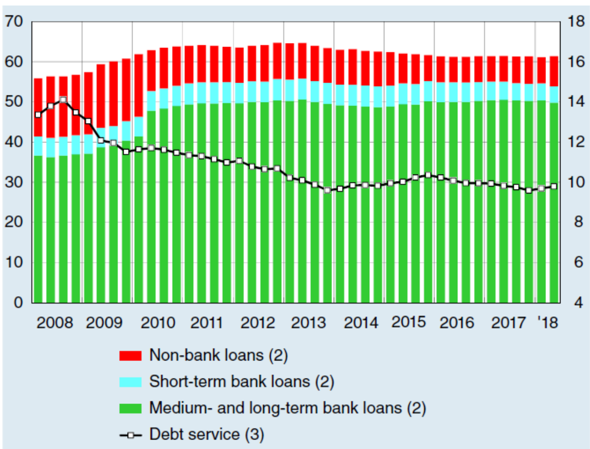
(HICP; y-o-y in p.p.)



Source: Istat, Eurostat

Household debt (1)

(quarterly data; as a percentage of gross disposable income)



Sources: Based on Bank of Italy and Istat data.

(1) End-of-quarter stocks and flows in the 12 months to the end of the quarter. The data for the last quarter are provisional. Debt includes securitized loans.

(2) In the second quarter of 2010 there was a methodological break in the computation of the statistics on the distribution between bank and nonbank loans. For the methodology, see the note in 'Monetary and Financial Indicators. Financial Accounts', Supplements to the Statistical Bulletin, 58, 2010.

(3) Right-hand scale. Estimated cost of debt service (interest plus repayment of principal) for consumer households only.

Non-financial corporations

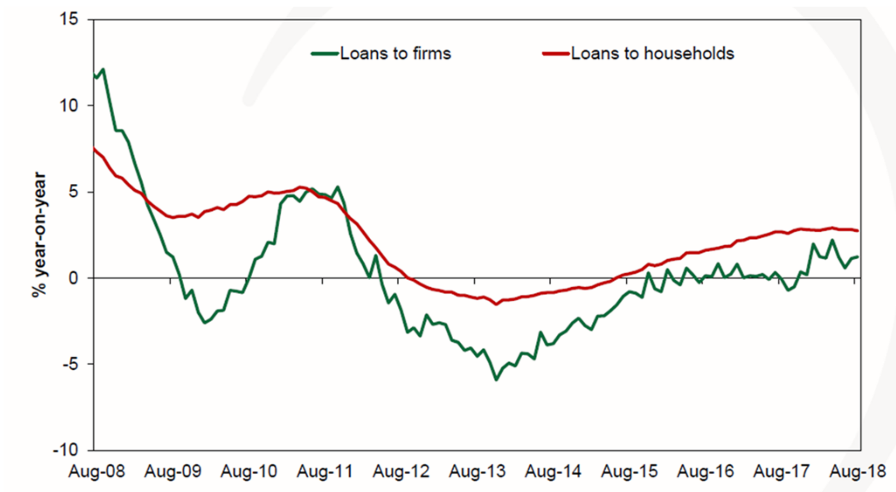
- The gross profit share of Non-financial corporations was 42.2% in the second quarter of 2018 compared to 42.3% in the previous quarter.
- Gross investment rate of Non-financial corporations was 21.9% in the second quarter of 2018, compared with 21.0% in the second quarter of 2017.

	II 2018	II 2018 on I 2018	II 2018 on II 2017	I-II 2018 on I-II 2017
	Millions of euro	Percentage changes		
Gross value added at basic prices	202,460	+0.1	+1.8	+2.3
Gross operating surplus	85,434	-0.2	+0.2	+0.9
Gross fixed capital formation	44,434	+2.6	+6.5	+6.9
	Percentage values	Changes in percentage points		
Gross profit share (a)	42.2	-0.1	-0.7	-0.5
Gross investment rate (b)	21.9	+0.5	+0.9	+1.0

(a) defined as gross operating surplus divided by gross value added
(b) defined as gross fixed capital formation divided by gross value added

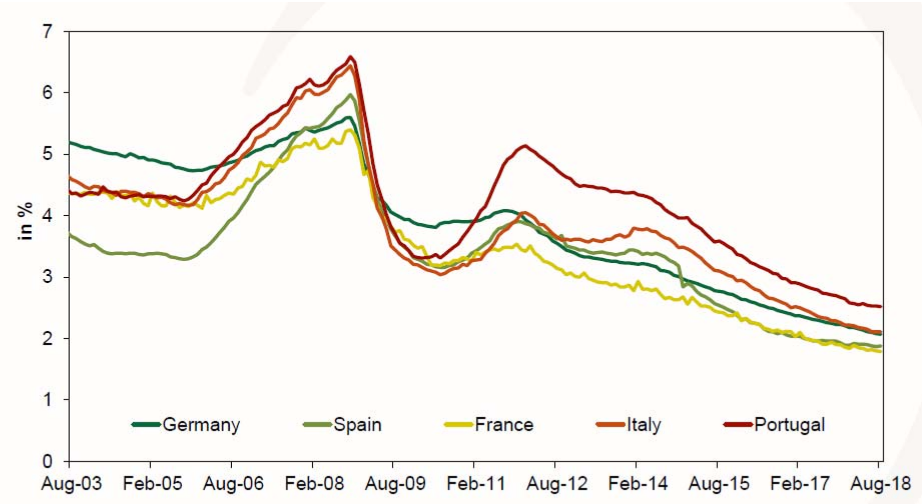
Source: ISTAT, Quarterly non-financial accounts by institutional sector (QSA), 3 October2018

Growth in bank lending remains positive



Source: Bank of Italy

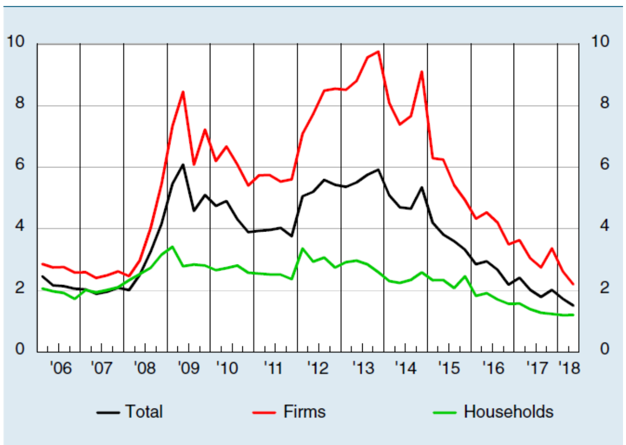
Bank lending rates remain low



Note: annual interest rates on loans (outstanding amounts). Source: ECB

New non-performing loan rate (1)

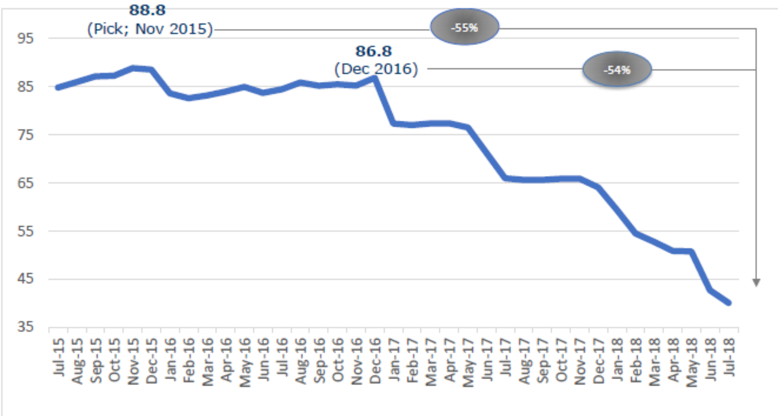
(per cent)



Source: Central Credit Register.
(1) Annualized quarterly flows of adjusted NPLs in relation to the stock of loans at the end of the previous quarter net of adjusted NPLs. Data seasonally adjusted where necessary.

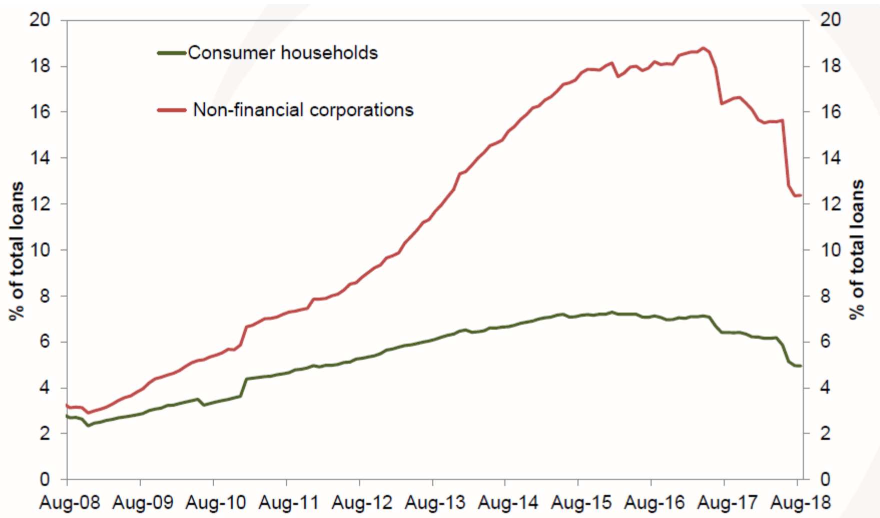
Net Bad loans ("sofferenze") down to 40.1 bln €, 55% less than the pick touched in November 2015 (88.8 bln €) and 54% less than the amount at year end 2016

Italian net bad loans (sofferenze)
(total Italian banks; July 2015 – July 2018; bln €)



Source: ABI on Bank of Italydata

NPLs as a share of bank loans are falling



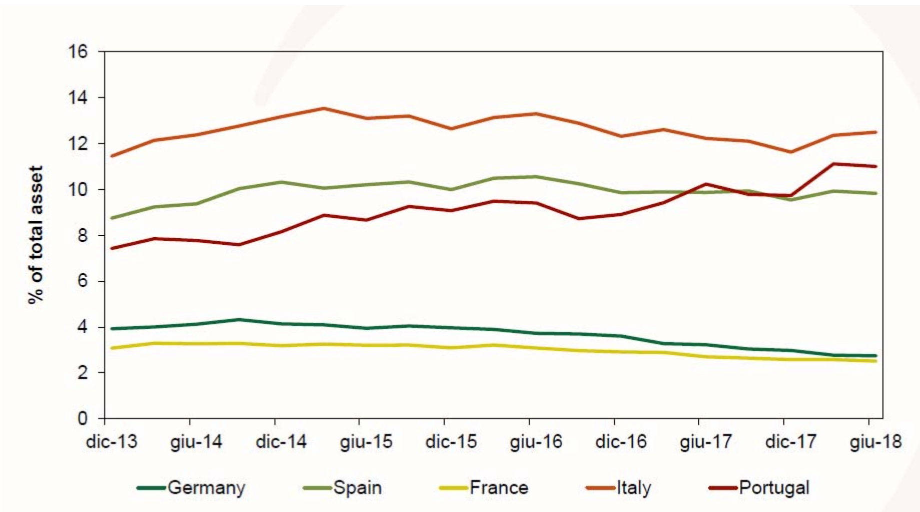
Source: Bank of Italy

Italian systemically relevant institutions are well capitalised

Q2 2018 *EUR billions, percentages*								
Country	**Total risk exposure amount**	**Total capital**		**Tier 1**		**CET1**		
		Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*	
Germany	1.204,28	230,13	19,11%	198,91	16,52%	185,48	15,40%	
France	2.429,40	427,70	17,61%	365,35	15,04%	338,00	13,91%	
Greece	170,72	27,96	16,38%	26,97	15,80%	26,95	15,78%	
Italy	***976,53***	***158,47***	***16,23%***	***135,60***	***13,89%***	***124,44***	***12,74%***	
Spain	1.439,63	215,97	15,00%	186,61	12,96%	166,15	11,54%	
Portugal	123,95	18,40	14,85%	16,66	13,44%	16,04	12,94%	

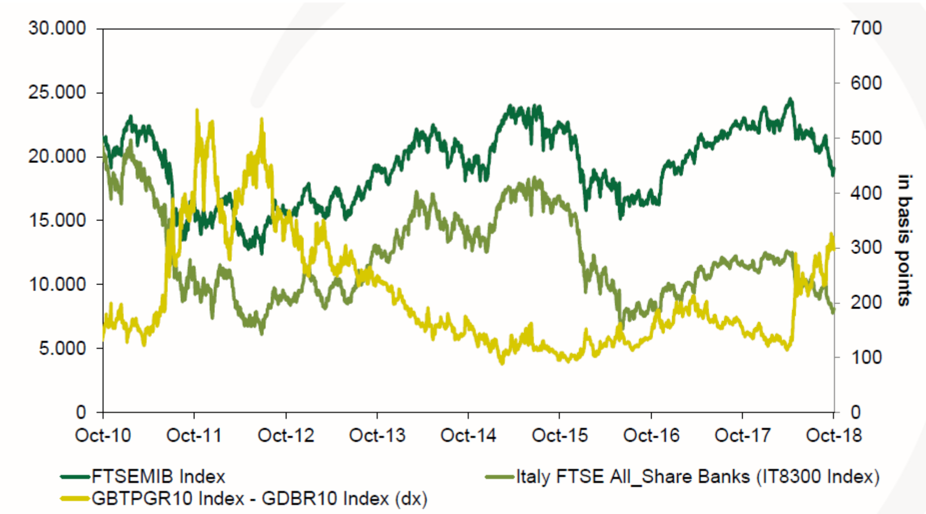
Source: ECB
Note: Countries are ordered by Total capital ratios. Significant institutions at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available.

Banks' holdings of government bonds recently rose



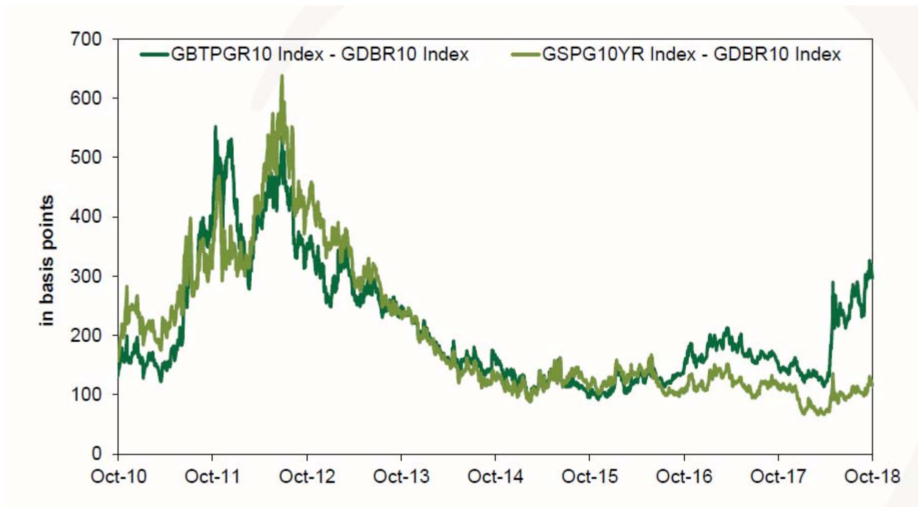
Source: ECB

A significant correction in Italian stock prices



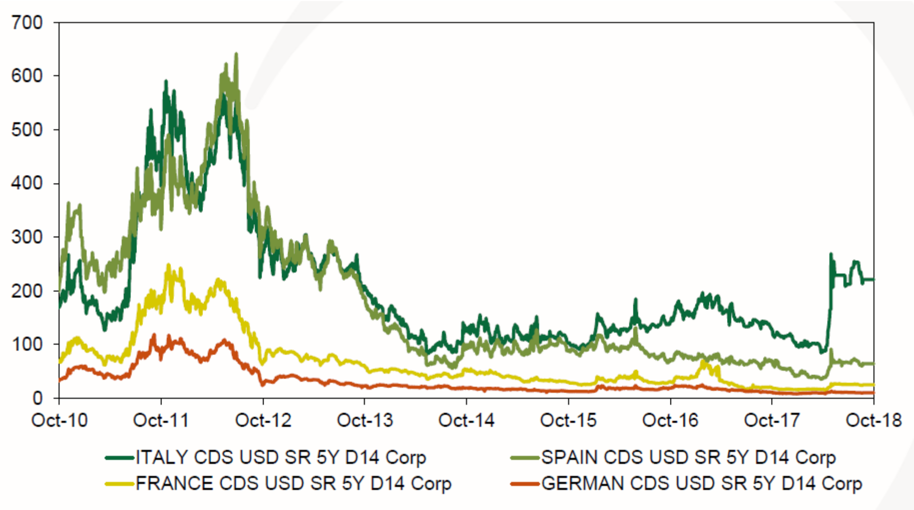
Source: Bloomberg

Sharp widening in the sovereign bond spread



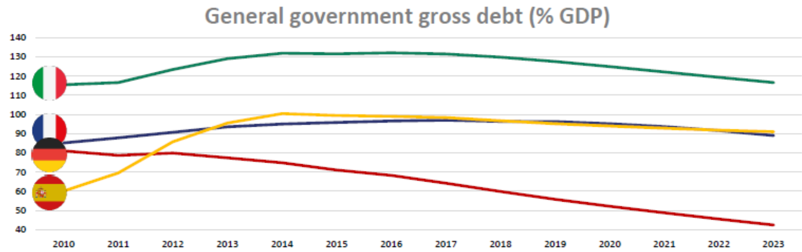
Source: Bloomberg

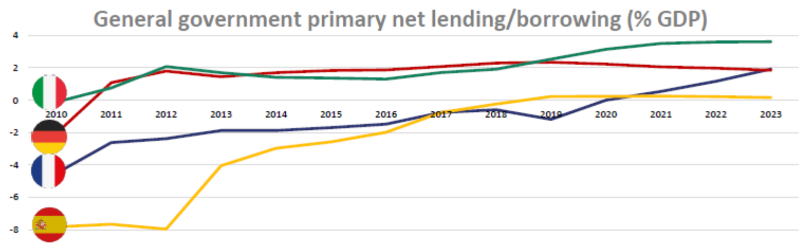
Sharp increase in CDS prices



Source: Bloomberg

Public finance: outlook and forecasts





Source: IMF

Budget forecasts for 2018-2021

- In 2017, the deficit was -2.4% of GDP vis-à-vis the target of -2.1% of GDP planned in the Update to 2017 EFD, due to the impact of measures to support the banking sector, which were worth 0.4% of GDP.
- For 2018, the nominal deficit in the first half of the year was in line if not better than the one projected by the 2018 Stability Program in April. The deficit outturn for this year is estimated at 1.8% of GDP.
- The structural balance in 2018 will be -0.9% of GDP, with a 0.2 percentage point improvement vis-à-vis 2017.
- The debt-to-GDP ratio recorded a moderate but constant reduction from a 2014 high of 131.8%, to 131.6% of GDP in 2015, 131.4% in 2016 and 131.2% in 2017 and is projected to decline to 130.9% in 2018.

Reform agenda: European Commission’s view

European Commission – Italy CSRs for 2018 and 2019*

- **Fiscal policy**
  Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an **annual structural adjustment of 0.6 % of GDP**. Use **windfall gains** to accelerate the reduction of the general government debt ratio. **Shift taxation** away from labour, including by **reducing tax expenditure** and reforming the outdated **cadastral values**. Step up efforts to **tackle the shadow economy**, including by strengthening the compulsory use of e-payments through lower legal thresholds for cash payments. **Reduce the share of old-age pensions in public spending** to create space for other social spending.
- **Governance**
  Reduce the **length of civil trials** at all instances by enforcing and streamlining procedural rules, including those under consideration by the legislator. Achieve more effective **prevention and repression of corruption** by reducing the length of criminal trials and implementing the new anti-corruption framework. Ensure enforcement of the new framework for **publicly-owned enterprises** and increase the efficiency and quality of local public services. **Address restrictions to competition**, including in services, also through a new annual competition law.

Reform agenda: European Commission's view - 2

- **Banking system and insolvency procedures**
  Maintain the pace of **reducing the high stock of non-performing loans** and support further **bank balance sheet restructuring and consolidation**, including for small and medium-sized banks, and promptly **implement the insolvency reform**. Improve **market-based access to finance for firms**.

- **Labour market and social spending**
  Step up implementation of the reform of active labour market policies to ensure equal access to effective job-search assistance and training. Encourage **labour market participation of women** through a comprehensive strategy, rationalising family-support policies and increasing the coverage of childcare facilities. **Foster research, innovation, digital skills and infrastructure** through better-targeted investment and increase **participation in vocational-oriented tertiary education**.

* European Commission, Recommendation for a COUNCIL RECOMMENDATION on the 2018 National Reform Programme of Italy and delivering a Council opinion on the 2018 Stability Programme, Brussels, 23.5.2018.

The outlook for the public finances

Draft Budgetary Plan 2019

Policy scenario						
% of GDP	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
General government balance	**-2.5**	**-2.4**	**-1.8**	**-2.4**	**-2.1**	**-1.8**
Structural balance (1)	*-0.9*	*-1.1*	*-0.9*	*-1.7*	*-1.7*	*-1.7*
Change in the structural balance	*-0.9*	*-0.2*	*0.2*	*-0.8*	*0.0*	*0.0*
Primary balance	**1.4**	**1.4**	**1.8**	**1.3**	**1.7**	**2.1**
Interest expenditure	**3.9**	**3.8**	**3.6**	**3.7**	**3.8**	**3.9**
Public debt (2)	**131.4**	**131.2**	**130.9**	**130.0**	**128.1**	**126.7**
Public debt ex support EA (3)	**127.9**	**127.8**	**127.6**	**126.8**	**125.0**	**123.8**

1)Net of one-off measures and cyclically adjusted. Discrepancies, if any, are due to rounding.
2) Gross of financial support to Eurozone countries.
3)Net of financial support given to other Euro area countries.
Source: ISTAT and Government projections for 2018-2021 (DBP 2019)

Real GDP forecast - components

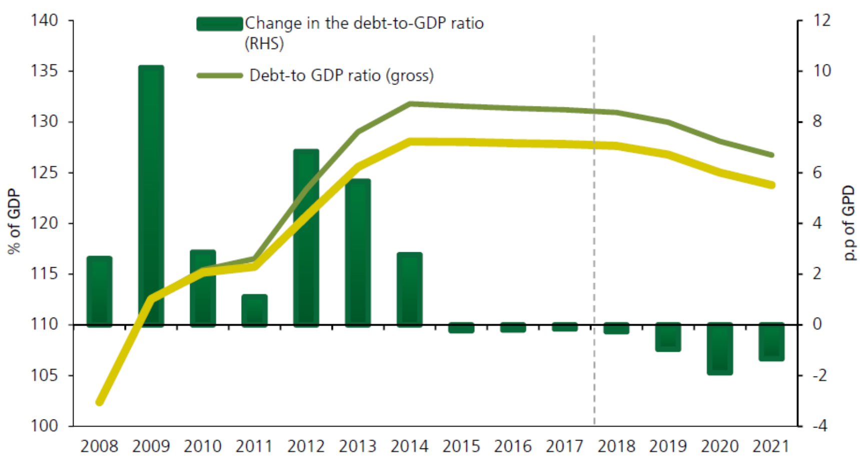
October 2018 forecast: GDP components

Policy scenario					
	2017	**2018**	**2019**	**2020**	**2021**
GDP	**1.6**	**1.2**	**1.5**	**1.6**	**1.4**
Imports	5.2	1.7	3.0	3.8	4.0
Final national consumption	1.1	0.9	1.2	1.2	1.0
Household consumption and NPISH	1.5	1.1	1.3	1.3	1.2
Government expenditure	-0.1	0.4	1.1	0.8	0.5
Investment	4.3	4.4	3.7	3.2	2.8
- machinery, equipment and other	2.3	3.1	4.0	4.1	3.7
- transport equipment	37.5	25.1	6.5	2.3	2.1
- construction	1.6	1.4	2.8	2.6	2.0
Exports	5.7	0.4	2.6	3.4	3.6

Source: ISTAT and Government projections for 2018-2021 (Draft Budgetary Plan 2019)

Key drivers of the debt/gdp ratio in the policy scenario

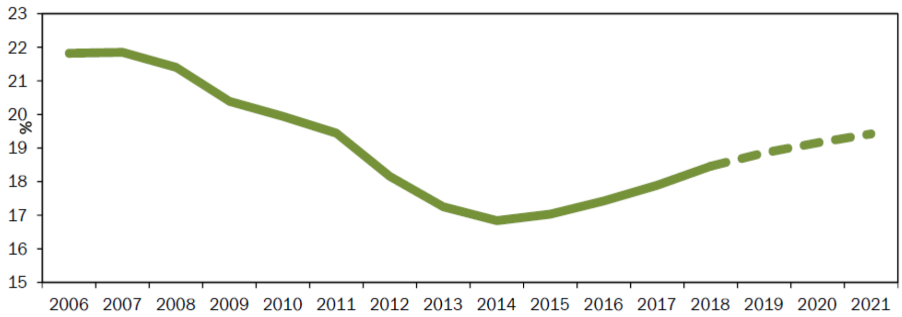
(% changes y/y and percentage points of gdp)



Source: MEF calculations on ISTAT data and Government projections for 2018-2021

Gross fixed investment

(as a % of gdp)



Source: MEF calculations on ISTAT data. Estimates from 2018 onwards

The new Budget and reform plan

- **Fiscal responsibility**
  Budget balance in 2019 will widen on a structural basis, but then remain stable in 2020 and 2021. Government reiterates commitment to balanced structural balance in the medium term.
- **Revitalising public investment, keeping current expenditure under control**
  Removing obstacles to public works, improving planning and coordination, raising capital expenditure. Spending Review embedded in the budgetary process.
- **Income tax reform**
  Simplified income tax for small businesses and self-employed. Corporate tax cut on reinvested earnings and payroll increases.
- **Inclusion policy**
  Citizenship Income and increased investment in job-placement centres. 'Dignity' policy package.
- **Welfare**
  Easing restrictions on early retirement, especially for workers with long contribution histories.