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ITALY: GROWTH IS UP BUT SIGNIFICANT FISCAL IMBALANCES REMAIN

Lucie Barette

The Italian economy has seen strong recovery since the end of the Covid-19 pandemic. Since 2021, its annual growth has far exceeded that recorded on average in the eurozone, thanks to the implementation of expansionary fiscal policies, which have buoyed consumption and investment, and the gradual recovery of tourism.

Since the beginning of 2023 however, economic activity has started to moderate, due to an unfavourable international environment and the gradual abolition of these fiscal measures.

In addition, the latter have, by their very nature, impacted the State's public finances, placing the country under the European Commission's excessive deficit procedure (EDP) in June 2024.

REAL GDP GROWTH IN SOUTHERN EUROPE

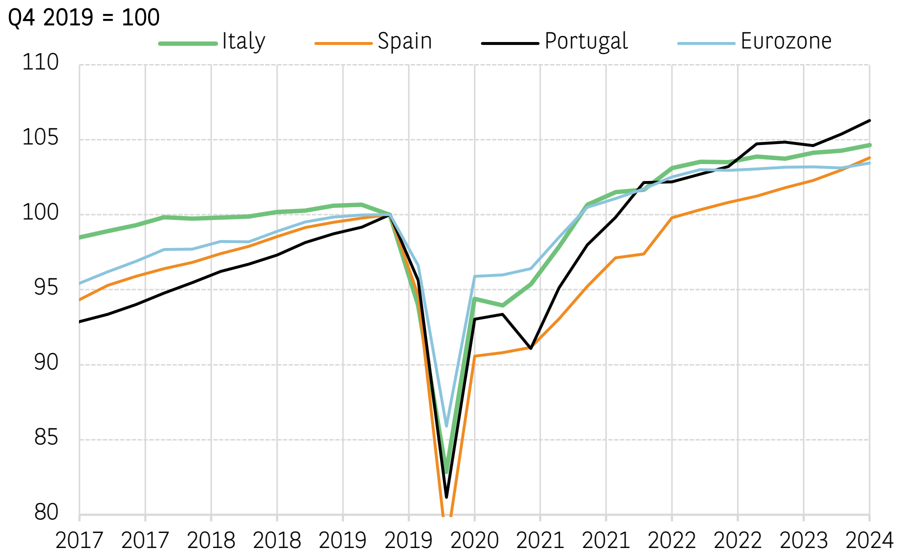

CHART 1

SOURCE : NATIONAL SOURCES, BNP PARIBAS

Along with the economies of Spain and Portugal, the Italian economy recovered well following the health crisis. Between 2021 and 2023, Italian real GDP growth was quite significantly higher than that recorded in the eurozone: in Q1 2024, Italian real GDP was 4.5% above its pre-pandemic level when that posted in the eurozone was 3.3% above its pre-pandemic level (See chart 1). This performance by Italy is remarkable because the country is better known for poor growth: apart from 2000, when Italian growth (4.1%) marginally exceeded growth in the eurozone (4%), the former was one percentage point lower than the latter on average per year between 1996 and 2019[1]. This post-Covid rebound was mainly bolstered by the favourable fiscal policies put in place by the Government (including, in particular, government-backed loans, measures to offset the rise in energy prices and the Superbonus tax credit mechanism), which supported private consumption and investment, and then by the gradual return of tourism. This recovery in Italian growth is also part of a longer-term trend of improvement in potential growth, which has been visible since 2014 according to OECD estimates (See chart 2).

1 In 2020, the Italian economy also suffered more from the recessionary shock of Covid, with GDP falling by 9% as an annual average compared to -6.2% in the eurozone.

MOVING TOWARDS MODERATION OF GROWTH

In 2023, however, Italian growth began to moderate (1.0% as an annual average). Although it once again outperformed growth in the eurozone (0.6%), the gap with other economies in Southern Europe widened: Spain and Portugal having recorded very strong growth rates (by 2.5% and 2.3%, respectively) for another year.

This slowdown in growth was brought about by an unfavourable international environment, with the slowdown in global trade and the weakness of Germany, which resulted in a contraction in export goods (-1.1% as an annual average). Nevertheless, the gradual return of tourism bolstered service exports (+8.3%) (See chart 3), which ultimately allowed total exports (as regards national accounts) to grow by 0.5% y/y.

In addition, Italian growth benefited, for another year, from the support of private consumption (contributing +0.7 pp to real GDP growth) (See chart 4). The latter benefited first, from the significant slowdown in inflation (HICP) – which fell from 12.6% y/y in October 2022 (peak) to 0.8% y/y in May 2024, mainly due to deflation in energy prices – and second, from the resilience of the labour market. Since the end of the pandemic, the unemployment rate has fallen significantly (7.2% in March 2024 compared to 10.2% in March 2021), and the employment rate (for 15-64-year-olds) has risen (62.1% in Q4 2023 compared to 56.1% in Q1 2021), although it remains below the euro zone average. The number of permanent contracts has also increased (+3.2% on an annual average in 2023), while the number of temporary employees decreased (-2.7%), suggesting an improvement in job quality and a reduction in precarious employment.

Compared to the previous two years however, private consumption contributed less to Italian real GDP growth in 2023. This can be explained in particular by the fact that, despite falling inflation, households suffered sharp losses in purchasing power, with wages rising by +4.2% in Q4 2023 compared to Q3 2021, while inflation rose by +16.7% over the same period.

And lastly, despite its gradual reduction over recent years, the tax benefit for energy improvement of buildings, also known as the Superbonus (see box below), has continued to have a positive effect on Italian investment. As a result, investment remains the other driver of Italian growth, with a contribution of +1.1 pp, primarily supported by investment in construction (contribution of 0.4 pp) (See Chart 5).

REAL EFFECTIVE GROWTH VS. POTENTIAL GROWTH (%CH Y/Y)

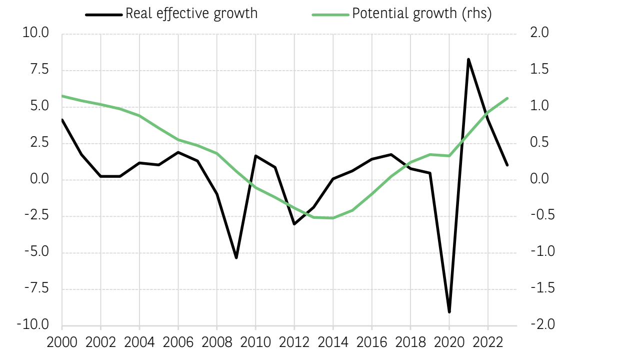

CHART 2

SOURCE : OECD, ISTAT, BNP PARIBAS

EXPORTS IN VOLUME

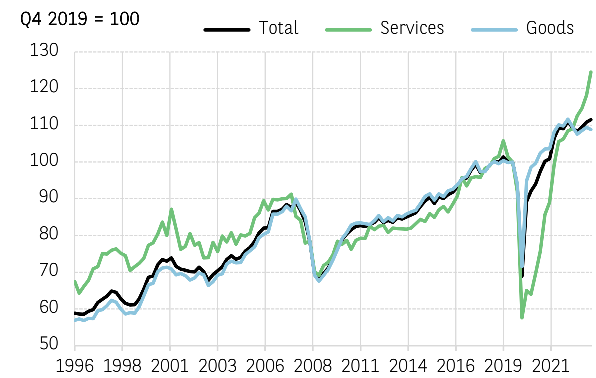

CHART 3

SOURCE : ISTAT, BNP PARIBAS

CONTRIBUTIONS TO REAL GDP GROWTH

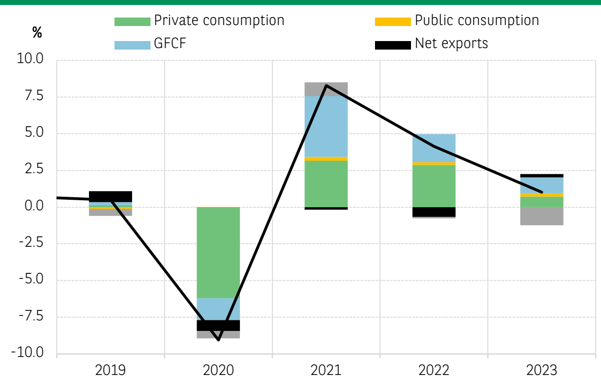

CHART 4

SOURCE : ISTAT, BNP PARIBAS

INVESTMENT, IN VOLUME

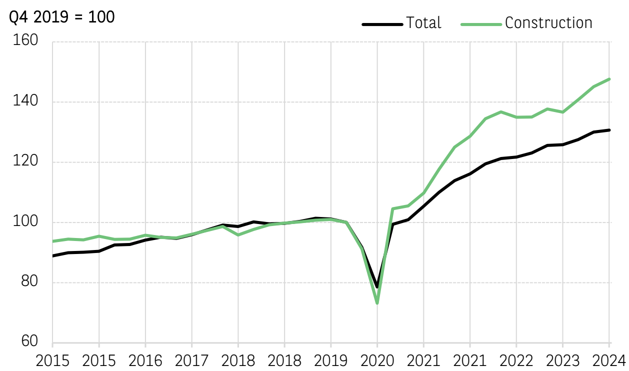

CHART 5

SOURCE : ISTAT, BNP PARIBAS

The Superbonus scheme

The Italian government introduced the Superbonus tax credit scheme in 2020 with the aim of mitigating the economic impact of the Covid-19 pandemic on households and businesses. This scheme initially allowed beneficiaries starting energy efficiency renovation work on their buildings to obtain a **tax credit equal to 110% of the costs incurred.**

This system was initially applicable in several ways:

- the beneficiary could **use it to reduce their tax** on their tax return over four or five years, in equal annual instalments;

- they could also opt for a **discount on the invoice** (partial or total) of the costs of the work, i.e., the companies carrying out the work could offer them an immediate discount in exchange for transfer of the tax credit; and

- lastly, they could opt to **transfer the tax credit for unused amounts**. It was therefore possible to transfer the tax credit to a third party, such as a bank or a company carrying out work, for immediate liquidity.

In 2023, the tax credit rate was reduced from 110% to 90% for most beneficiaries. Only those who began work on their private home in 2022 still benefited from the 110% rate until 31 March 2023, provided that at least 30% of the work was carried out before 30 September 2022. Work on jointly-owned buildings or buildings owned by cooperatives and non-profit organisations also benefited from this rate extension to 110%, if the work had been approved before the end of 2022.

In 2024, conditions became tighter once again. The rate was reduced from 110% to 90% until 31 December, for work carried out on jointly-owned properties, and for work carried out by owners of private homes whose tax income is less than EUR 15,000. With regard to work carried out on buildings owned by cooperatives, non-profit organisations and public housing organisations, the tax credit rate was reduced to 70% in 2024 and will be reduced to 65% in 2025.

INCREASE IN FISCAL CHALLENGES

Italy's fiscal situation, as in most other eurozone countries, has deteriorated compared to 2019. This deterioration is due to the «whatever it takes» policies put in place during the health crisis and then the energy shock, via tariff shields and other aid that helped buoy economies following the massive rise in inflation.

While the fiscal rules of the Stability and Growth Pact (SGP) were suspended between 2020 and 2022 due to exceptional circumstances, they were reactivated for the 2023 evaluation. It turns out, to no-one's surprise, that Italy does not meet the deficit criterion[2], which is a prerequisite for the official opening of an excessive deficit procedure by the European Commission.

In 2023, Italy's fiscal deficit not only remained the largest in the eurozone (-7.4%; -5.9 GDP points compared to 2019), but it was also finally well above what the government had initially forecast (+2.1 pp). This increase in the fiscal deficit can be attributed to the increase in public spending (by 6.7 GDP points over the period 2019-2023), particularly under the effect of tax credits (+4.3 GDP points [3]), and more particularly the Superbonus scheme. Compared to 2022, however, the fiscal deficit fell slightly (+1.2 pp) thanks to the reduction in aid intended to cushion the energy shock, but also thanks to the decrease in the primary deficit (-3.6%; +0.7 pp over a year) (See chart 6).

BUDGET BALANCES

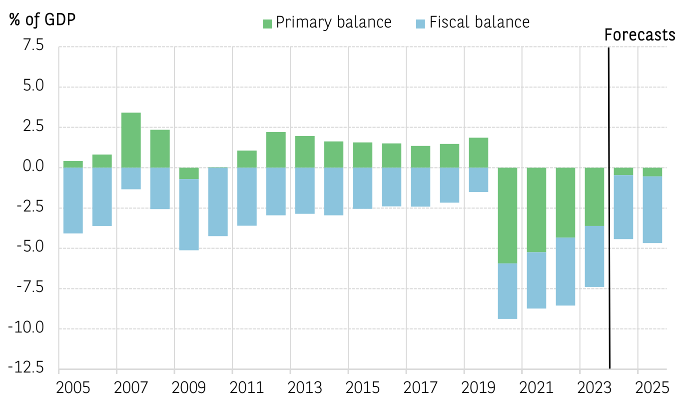

CHART 6

SOURCE : DG ECFIN AMECO, BNP PARIBAS

2 According to the report under Article 126(3) of the Treaty on compliance with the deficit and debt criteria, 19 June 2024, European Commission (*1d91e302-b9cc-4b54-988a-9e6787230152_en (europa.eu))

3 According to the article by F. Ecalle «Les finances publiques des pays de la zone euro en 2023» [Public finances in eurozone countries in 2023], 30 April 2024, FIPECO (FIPUzone euro2023.pdf (fipeco.fr))

As a percentage of GDP, Italian public debt remained the second highest in the eurozone in 2024 (137.7%), behind Greece (161.9%) (See chart 7). Although it declined rapidly following its peak recorded in 2020 due to the strong recovery in nominal growth, and therefore a more favourable growth and interest rate differential («snowball effect») between 2021 and 2023, it still remains 3.2 points above its 2019 level.

For 2023, Italy is therefore not meeting the deficit and debt criteria set out in the European governance framework. Moreover, these imbalances are not characterised as temporary by the European Commission. In its spring forecasts, the latter indicates that Italy's fiscal deficit is expected to continue to significantly exceed the 3% threshold forecast by the SGP over the next two years (-4.4% in 2024 and -4.7% in 2025, under the technical assumption of unchanged fiscal policy). Due to the slowdown in the nominal growth rate in the coming years, implying a less favourable «snowball» effect, and possible repayments of Superbonus tax credits, the public debt-to-GDP ratio is expected to increase in 2024 and 2025 (138.6% and 141.7%, respectively).

Nevertheless, Italian public finances benefit from fairly significant risk-mitigating factors. Debt structure is one of these factors, with a fairly long average residual maturity (6.9 years), entailing a gradual repercussion of higher interest rates on debt servicing. In addition, fiscal risks are also mitigated by a higher net international investment position surplus in 2023. This reflects both an increase in the share of public debt in residents' assets, and the reduction in the Italian banking system's debtor position towards its eurozone partners (mainly Germany), which peaked in 2022.

In any case, at the end of September, Italy will have to communicate to the European Commission how it intends to reduce its excessive deficits. Although the reform of the European governance framework was adopted in spring 2024, and the new fiscal rules are more flexible due to the fact that countries now have more time to balance their public accounts (between four and seven years depending on the analysis of the sustainability of their public debt), the goals remain to reach a public debt-to-GDP ratio of 60% and a deficit of less than 3%. If commitments are not met, the country will risk financial sanctions of up to 0.1% of GDP each year. According to the Bruegel Institute[4] , Italy will also be the country that will have to make the largest fiscal adjustment, in the order of 1.08% of GDP on average per year for a four-year adjustment period, or in the order of 0.59% per year for a seven-year adjustment period.

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PUBLIC DEBT RATIOS

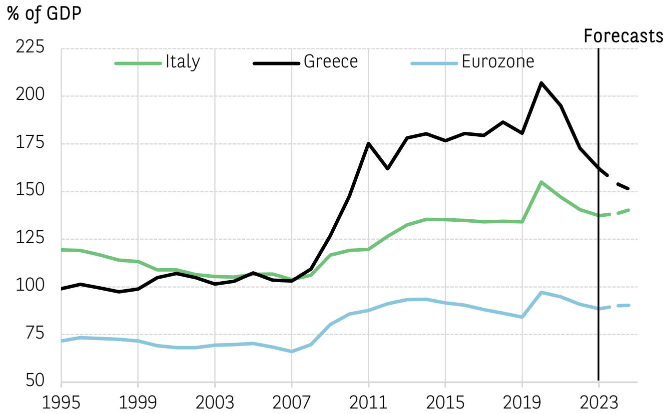

CHART 7

SOURCE : EUROSTAT, DG ECFIN AMECO, BNP PARIBAS

4 Article «The implications of the European Union's new fiscal rules», 20 June 2024, Bruegel Institute (https://www.bruegel.org/policy-brief/implications-european-unions-new-fiscal-rules)

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