Italy in the Global Economy
Prometeia Brief

July 2017 – No. 17/5

Executive summary

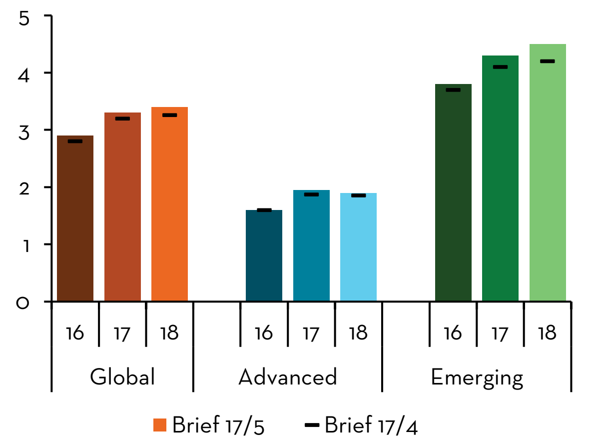
The global recovery is getting stronger

- World trade has continued to improve and GDP growth in 2017 Q1 rebounded in a number of emerging countries and accelerated in the EMU.
- For the Euro area, the latest industrial production data confirm the good momentum. The economic recovery is projected to continue at a fast pace, thanks to a favorable external context and a more sustained domestic demand.
- US short term indicators do anticipate a positive GDP rebound in 2017 Q2, but we expect weaker growth and a weaker dollar in 2017 and 2018 due to a less expansionary fiscal policy compared to our May forecast.
- Data on the Chinese economy show that activity continued to increase at a very robust pace, but public spending is being contained, anticipating a deceleration of the GDP growth rate in the second half of 2017.
- Overall, the global economic recovery is projected to expand slightly faster than we anticipated in our May Brief (Chart 1).

Italy, positive surprises

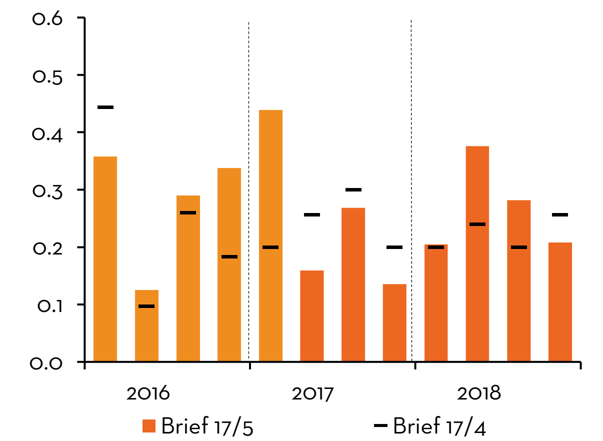
- The latest data for 2017 Q1 revised GDP growth rate upwards to 0.4 per cent qoq, from 0.2 in the previous release, and from 0.2 to 0.3 per cent growth in 2016 Q4 (Chart 2). Some statistical factors suggest that these modifications should be considered with some caution.
- We have revised our projection of GDP growth for 2017 upwards from 0.9 per cent to 1.2, the highest rate since 2010.
- Energy and unprocessed food continued to reduce consumer inflation in June, while core inflation increased, also reflecting the expansion in household consumption.
- Our projection sees Italy moving to a moderate fiscal tightening from 2018, aimed at reducing the debt-to GDP ratio.
- Our two InFocus report the impact on the budget deficit of a higher than expected increase in interest rates and the recent rescue of the two Venetian banks.

Chart 1 **Real GDP**
% change



Source: Prometeia's forecasts on IMF, World Bank, Eurostat, National Statistical Offices.

Chart 2 **Italy: real GDP**
% change qoq



Source: Prometeia's forecasts on Istat data.

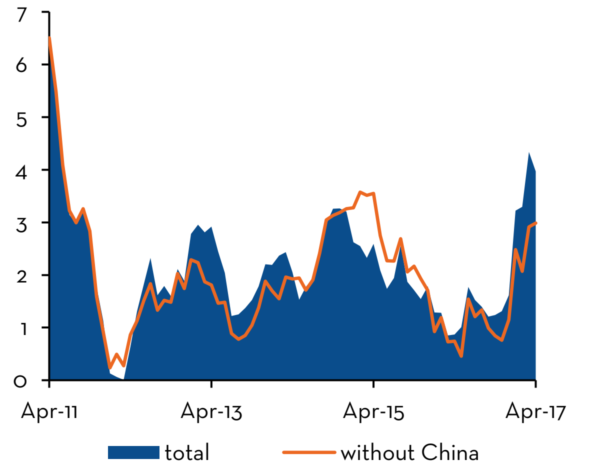
Global Scenario

World trade expands... Global trade hit growth rates greater than 4 per cent at the beginning of the year, driven mostly by emerging market economies, and especially by the strong revival of Chinese trade (Chart 3).

...and momentum in global activity is improving. Over the last few months, positive signals have intensified in the world scenario but with some qualifications. Among the emerging economies, the number of countries experiencing economic difficulties has fallen, as shown by the widespread improvement of the Purchasing Manager Index (PMI). GDP growth finally recovered in Brazil and Russia in 2017 Q1 and their inflation rates have turned in line with the central bank targets. In the US, the economic situation remains mixed: notwithstanding the improved labour market conditions, the confidence climate of households and businesses deteriorated in May. In the Euro area, the recent data on industrial production have improved further across countries, pointing to continued significant growth in the short term.

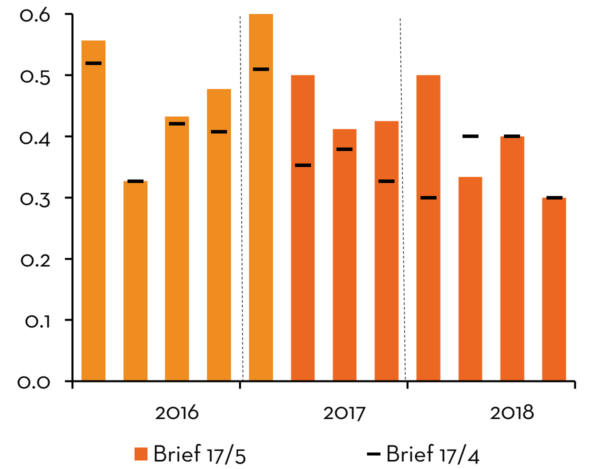
Macron's victory changes the European scenario. The scope of Macron's victory gives him leeway to introduce important reforms in France and negotiate European reforms with the next German administration. Brexit negotiation has just started and in our view it should not lead to a dramatic break, not least because of the highly integrated value chains between the EU and the UK. As external demand strengthens and political risks have largely diminished we have revised EMU GDP growth from 1.7 per cent to 1.9 in 2017, and from 1.4 percent to 1.7 in 2018 (Chart 4).

Chart 3 World trade
% change yoy



Source : Prometeia's calculations on CPB data.

Chart 4 UEM: real GDP
% change qoq



Source: Prometeia's calculations on Eurostat data.

Towards the normalization of monetary policy rates, but at a moderate pace. The Fed has announced the possibility of starting to reduce its balance sheet within the year. Contrary to initial expectations, the budget plan presented to Congress on May 23 does not foresee an expansive stance in 2018. Overall, we hold on our May forecast of two rate hikes of 25 bp in 2018.

In the Euro area, consumption inflation does not seem able to stabilize on values consistent with the ECB's target. The strengthening of the Euro exchange rate, together with global commodity price developments and the high labor supply potential, keep domestic wage and price pressures subdued. We confirm our forecast of a continuation of QE until the end of this year and a tapering that, from June, will cease to increase the ECB's balance sheet.

In this context, the only divergence will be BOJ's operations aimed at maintaining stimulus on the economy and preventing government bond yields from rising further.

Little pressure on the horizon for commodity prices. Oil prices have declined in the last two months but we do not expect them to fluctuate around the current levels for a long time. They should return to around 50 dollars a barrel at the first sight of distress in US shale production.

Italy

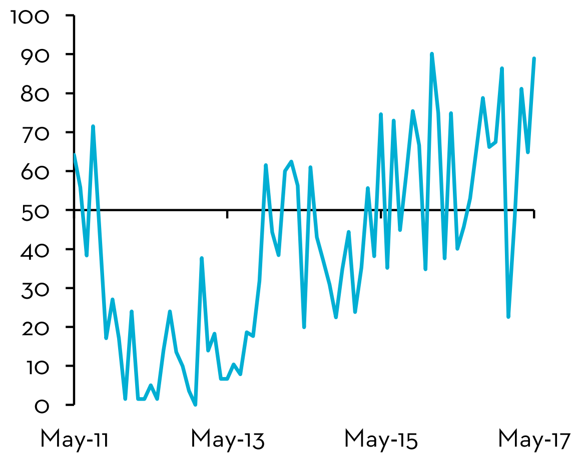
GDP growth better than expected. The recent upward revision of GDP data in 2017 Q1 and 2016 Q4 shows that the Italian recovery is getting stronger. GDP growth accelerated slightly in 2017 Q1 thanks to the large contribution of inventories, and the strengthening of household consumption and investment in construction. In contrast, investment in machinery and equipment has been disappointing. It declined by 2 per cent, probably because of the uncertainty regarding the continuation of the fiscal incentives beyond 2016 pushing at the end of 2016 firms to anticipate investment spending. After its strong support for investment growth in 2016, investment in transport remained at the level reached in the previous quarter. The contribution of net exports to GDP growth was negative due to a larger increase of imports compared to that of exports. Exports continued to increase, mainly to EU countries, driven by improvements in external demand and price competitiveness.

In May, industrial production increased by 0.7 per cent mom and Prometeia's index of growth diffusion among sectors reached the high value of 90 per cent (Chart 5). We also expect an expansion in June by 0.4 per cent (0.7 per cent in 2017 Q2 qoq).

Labour supply continued to increase. In the first five months of this, year compared to the same period of 2016, the number of people employed increased by 243,000, despite the end of the fiscal incentives on new hires. The unemployment rate continued to fall at a slow pace, in part due to the labour supply increase, which is a feature of this latest recovery. This dynamic reflects the entry of discouraged job seekers into the labour market, as well as new retirement rules, which have continued to raise the minimum age of retirement, with a corresponding increase in the activity rate of older employees.

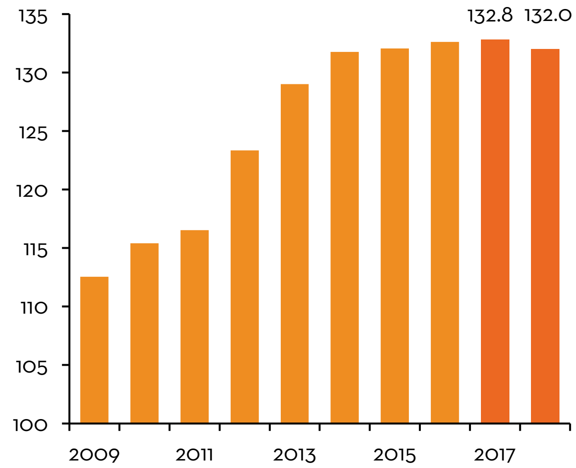
The risk of deflation has faded away. The recent data show a further sharp decline in June of consumer price inflation, due to the reduction of energy and unprocessed food prices. In contrast to that, core inflation accelerated sharply and has more than doubled in the last 8 months. The recent rise is mainly caused by the impact of seasonal effects on prices related to transport. Also, inflation related to restaurant and hotel services accelerated, especially driven by tourism. Aside

Chart 5 **Italy: Prometeia's index of growth diffusion of industrial production**
%



Source: Prometeia's calculations on Istat data.

Chart 6 **Italy: public debt-to-GDP ratio**
%



Source: Prometeia's forecasts on Istat data.

from seasonal factors, the dynamism of these prices reflects the sustained pace of economic activity and of household consumption, in particular. We expect consumer inflation in 2017 to reach 1.5 per cent (it was -0.1 per cent in 2016).

Fiscal stance... In 2017, the deficit-to-GDP ratio is projected to decline slightly, to 2.2 per cent from 2.4 per cent in 2016, thanks to a stronger economic recovery as well as a further decrease in interest expenditure. The supplementary restrictive measures adopted in April, as requested by the European Commission mainly to enhance tax compliance, will contribute to partially offset the reduction in the tax burden driven by the measures introduced by the 2017 budget law (especially targeted to business tax relief).

...will change in 2018, becoming slightly restrictive. For the coming years, the Italian Government's fiscal plan entails a substantial fiscal adjustment. However, the government has received the preliminary approval by the European Commission for a milder adjustment for 2018. The final approval will be given once the details of the 2018 Budget Law will be known. We predict that this structural adjustment will be about 0.3 per cent in 2018, enough to reduce the debt-to-GDP ratio to 132 per cent from 132.8 in 2017 (Chart 6).

Credit to the private sector is growing, but firms' loans are stagnating. In May, household credit growth was still in line with the EMU average (2.5 per cent yoy). The low interest rates and the improved real estate sector outlook have continued to fuel the demand for mortgages (2.3 per cent). Meanwhile, the strengthening of the labour market and the increase in household disposable income have sustained the increase in demand for consumer credit (8.6 per cent). In contrast to this, in the first five months of 2017, non-financial corporation loans stagnated, increasing only by 0.3 per cent yoy. This reflected the fall in investment demand, the wide availability of internal resources and the increase in alternative financing options on the market, like mini-bonds.

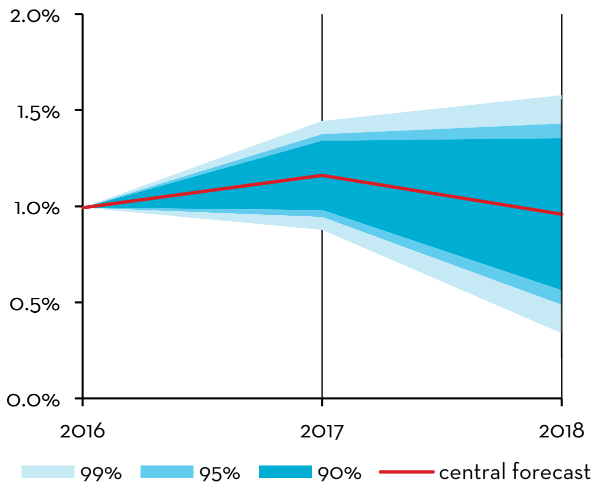
Interest rates are stabilizing. In May, interest rates for new loans to firms and for mortgages increased slightly. Over the last five months, interest rates on loans stopped falling and have hovered around historical low levels. The BTP/Bund spread dropped to 176 bp in June and we expect that in the coming few months it could increase slightly, driven by the uncertainty surrounding the results of the next national elections.

Banking sector less risky. Italian banking system risk factors have diminished thanks to the resolution of the two Venetian banks (cfr. Infocus), but the high level of NPLs still represents an area of vulnerability. In May, the stock of bad loans was worth €1.3 billion more than at the end of 2016: €0.7 billion were corporate loans and the rest, €0.6 billion, household loans. The ratio between bad debts (gross of provisions) and total loans for non-financial corporations decreased slightly in May, except for those firms that were affected most by the crisis (construction sector). Starting from 2017, we expect a reduction of NPLs by €38 billion, thanks to the sale of bad loans in particular and to the improvement of the economic cycle.

Risks to the projection

- Political uncertainty could intensify and become a major constraint on growth in Brazil and in South Africa.
- In the United States, the Trump administration is still having difficulties finding a strong majority to support some economic measures and downside risk includes an increase in trade protectionism.
- The Italian recovery is getting stronger but Italy is still in a delicate position due to the usual issues: the fragile banking system and high public debt, in particular, and the potential destabilizing effects of the next political elections.
- On the positive side, our caution in interpreting recent GDP data could be excessive, and the recovery might well be stronger than we predict.
- These factors increase the uncertainty surrounding our predictions on Italian GDP growth (Chart 7).

Chart 7 Italy: Prometeia forecast of annual GDP growth
central projection and confidence levels



Source: Prometeia's calculations.

InFocus

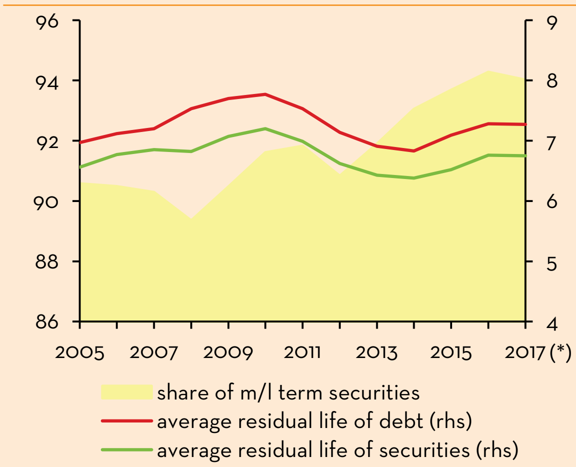
The effect of higher interest rates on Italian public finances

Despite the recent recovery of the Italian economy, there remain some elements of concern that could increase the risk of a declining confidence in Italian sovereign bonds. Higher maturities of medium- and long-term securities and the reduction of purchases under the QE programme represent additional critical elements to the uncertainty surrounding the Italian and international political context, which have determined the rising spreads of the past months. Furthermore, the end of tapering, which is expected for mid-2018, could also have a negative impact on new debt issuances as well as on the performance of the secondary market. But to what extent do less attractive bonds imply a sustainability risk for Italian public finances?

The debt exposure to interest rate and refinancing risks is correlated not only to the outstanding debt stock but also to the distribution of maturities, the share of fixed-rate and long-term securities, and the average residual maturity. Regarding With regard to Italy, these indicators, which have improved in recent years, show a relatively low degree of vulnerability of its public debt. Even in the first months of 2017 (Chart A) the funding shifted further towards the medium- and long-term, despite the increase in the spread. The average residual life of the debt rose to 7.27 years at the end of April (from 6.77 in the summer of 2014), that of securities to 6.75 years (6.2 was the lowest value reached during the crisis) and the share of fixed-rate bonds exceeded 73.5 per cent again. While 94 per cent of total securities have a maturity of more than 1 year, 62.5 per cent have a maturity of more than 10 years.

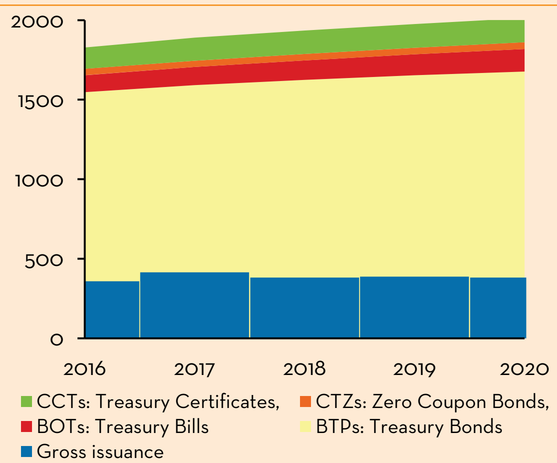
Under these conditions, the impact of higher yields takes time to fully pass-through to the public budget balance.[1] In the case of 100 bps along the whole curve, and considering a uniform monthly distribution of placements maintaining the current structure (Chart B), we estimate that the higher interest expenditure would be about €2.4 billion for the first year, and about 4.7 and 6.9 for the second and third years respectively (in terms of GDP, 0.14pp, 0.26pp, 0.39pp). Therefore, the slow transmission dynamics would leave time to calibrate the issuance strategies and implement corrective measures to limit their impact on the budget balance.

Chart A **Public debt: average residual life** *(years)* **and share of medium- and long-term** *(m/l)* **securities** *(%)*



Source: Bank of Italy and MEF. (*) March for the average residual life of securities, April for the other indicators.

Chart B **Stock of Italian government securities and gross issuance, dated at 12/31/2016**
billions of Euros



Source: Prometeia's forecasts on Bank of Italy data.

1 The Italian Ministry of the Economy and Finance (MEF) estimates the Average Refixing Period - the average time in which debt transposes market rates at 5.66 years in 2016, compared to 5.42 in 2015.

The orderly liquidation of the Venetian banks

On 23 June, the ECB determined that Veneto Banca S.p.A. (Veneto B.) and Banca Popolare di Vicenza S.p.A. (BP Vicenza) "were failing or likely to fail"[2] and the SRB (Single Resolution Board) decided that resolution action was not warranted for these banks. The determination came after a long process involving many players: in addition to the ECB and the SRB, the Directorate-General for Competition of the European Commission, the Italian Ministry of Economy and Finance (MEF) and the Bank of Italy. In particular, the Commission has to approve any measure involving public money by ensuring that it is in line with the rules on State aid and, in particular, with the Banking Communication of 2013.

The onset of the difficulties weighing on the two banks can be traced back to the capital shortfalls identified by the comprehensive assessment carried out in 2014. Since then, the two banks have struggled to overcome high levels of NPLs (Chart C), with significant repercussions on their balance sheets (losses from 2014 to 2016, Chart D) and capital ratios.[3] In the last three-years, the two banks have recapitalized for a total of around €5 billion, including the €3.5 billion invested by the Atlante Fund, which came to control almost their entire capital. Moreover, the banks have been unable to offer credible solutions going forward, like the business plan submitted to the ECB in February that proposed a merger and recapitalization to be accomplished by the end of 2017. On 17 March 2017, the two banks therefore informed the MEF, the Bank of Italy and the ECB about their intention to request precautionary recapitalization.

Following the decisions of the European authorities, and in compliance with the national legislation[4], on 25 June, the Italian Government issued a decree containing the guidelines for the execution of an administrative liquidation procedure, based on the Bank of Italy's proposal. The decree also allows for public intervention in order to guarantee an orderly implementation of the liquidation procedure, conditional on the arrangement of "burden sharing" measures and of financial support during the sale process of the banks or of some of its branches.

Chart C **NPL ratio and coverage ratio, 2014-2016 aggregated group average Veneto Banca e BP Vicenza** %

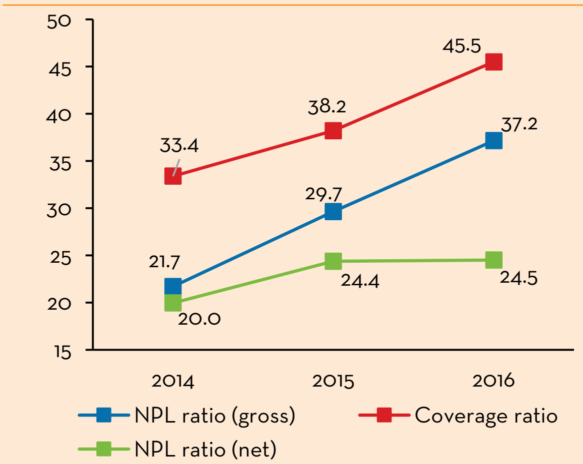
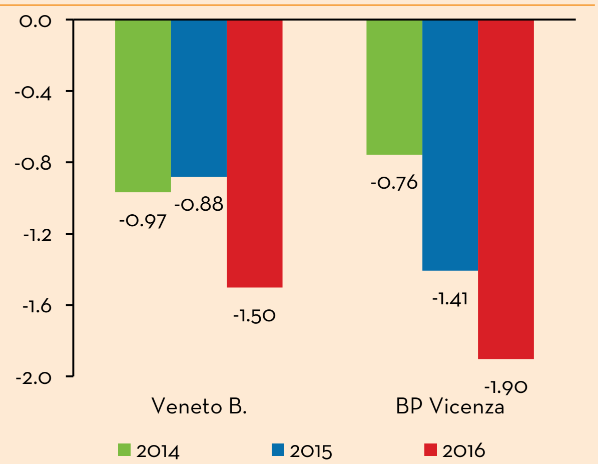


Chart D **Losses, 2014-2016 Veneto Banca e BP Vicenza**
billions of Euros



Source: Prometeia's calculations on balance sheet data.

2 https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html.

3 The Common equity ratio as of 31 December 2016 was equal to 7.5 per cent and 6.4 per cent for Veneto Banca and BP Vicenza, respectively, and stands at a lower level than the SREP requirement of 8.5 per cent, notwithstanding the latest capital increases.

4 Legislative Decree 25 June 2017.

The Bank of Italy appointed the liquidators, who sold the banks' assets and liabilities to Intesa Sanpaolo (ISP). The group, which had previously shown interest in acquiring the two institutes, signed the agreement for the purchase, at a "token" price of 1€, of the banks' assets and liabilities, excluding NPLs (bad loans, unlikely-to-pay loans and past due exposures), subordinated bonds issued, as well as shareholdings and other legal relationships not considered functional to the acquisition. The banks' NPLs will be transferred then to a publicly owned company (Società per la Gestione di Attività, SGA). At this stage of the proceedings, ISP will receive government support for about €4.8 billion (€3.5bn to sterilize capital impact from the consolidation of RWAs and €1.285bn for restructuring costs) plus guarantees on various risks related to the acquisition.

The holders (individuals or individual entrepreneurs) of subordinated debt of the two banks acquired by before June 12, 2014 will be reimbursed for 80 per cent of the amount paid for the purchase through the Solidarity Fund. In addition, Intesa Sanpaolo has allocated another €60 million to reimburse bondholders.

Table 1 The World Economy main indicators *% change*

	2016	2017	2018
World real GDP	2.9	3.3	3.4
World Trade	1.5	3.7	3.2
Manufactures prices $	-3.4	1.1	2.9
Brent oil price ($/brl, level)	45.1	52.5	53.3
GDP			
- United States	1.6	2.1	2.2
- Japan	1.0	1.1	1.0
- EMU	1.7	1.9	1.7
- China	6.7	6.6	6.2
Consumer prices			
- United States	1.3	1.9	2.3
- Japan	-0.1	0.3	0.5
- EMU	0.2	1.6	1.4
- China	1.9	3.6	3.4
$/€ exchange rate (level)	1.11	1.10	1.12
£/€ exchange rate (level)	0.818	0.865	0.872

Table 2 Italy main indicators *% change*

	2016	2017	2018
GDP	1.0	1.2	1.0
Imports of goods fob and services	3.1	4.9	2.7
Private consumption	1.3	1.1	0.9
Government consumption	0.6	0.5	-0.2
Gross fixed investment:	3.1	2.0	2.1
- machinery, equipment, other prod.	4.6	2.6	2.3
- costructions	1.4	1.4	1.9
Exports of goods fob and services	2.6	3.6	2.8
Domestic demand	1.1	1.5	0.9
Industrial production	1.9	2.0	1.8
Trade balance (% of GDP)	3.6	3.5	3.6
Terms of trade	3.2	0.3	0.3
Consumer prices	-0.1	1.5	1.1
Per capita wages - manufacturing	0.3	1.1	1.3
Total employment	1.4	0.7	0.4
General government balance (% of GDP)	-2.4	-2.2	-1.9

Table 3 Exchange Rates and Interest Rates

		17 Q1	17 Q2	17 Q3	17 Q4	18 Q1	18 Q2	18 Q3	18 Q4
Exchange rates vs euro	US dollar	1.07	1.10	1.12	1.12	1.12	1.12	1.12	1.12
	Yen	121.6	122.0	123.4	123.4	125.4	125.4	126.6	126.6
3 month interest rates	US libor	1.07	1.19	1.28	1.32	1.43	1.60	1.68	1.83
	Euribor	-0.33	-0.33	-0.33	-0.33	-0.31	-0.30	-0.25	-0.18
10 year government bond yields	US	2.44	2.28	2.25	2.32	2.46	2.58	2.65	2.78
	Germany	0.25	0.29	0.27	0.29	0.31	0.35	0.50	0.65
	Italy	2.15	2.20	2.14	2.26	2.28	2.20	2.21	2.27

Table 4 Real GDP comparison of the forecasts - *% qoq and annual % change* - *historical data in bold*

		17 Q1	17 Q2	17 Q3	17 Q4	2017	18 Q1	18 Q2	18 Q3	18 Q4	2018
United States	Brief 17/4	**0.2**	0.6	0.7	0.6	2.1	0.5	0.7	0.7	0.6	2.5
	Brief 17/5	**0.4**	0.7	0.4	0.6	2.1	0.4	0.7	0.6	0.5	2.2
EMU	Brief 17/4	**0.5**	0.4	0.4	0.3	1.7	0.3	0.4	0.4	0.3	1.4
	Brief 17/5	**0.6**	0.5	0.4	0.4	1.9	0.5	0.3	0.4	0.3	1.7
Italy	Brief 17/4	**0.2**	0.3	0.3	0.2	0.9	0.2	0.2	0.2	0.3	0.9
	Brief 17/5	**0.4**	0.2	0.3	0.1	1.2	0.2	0.4	0.3	0.2	1.0

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