ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia ASSOCIAZIONE

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Executive summary

Dark clouds over the global outlook

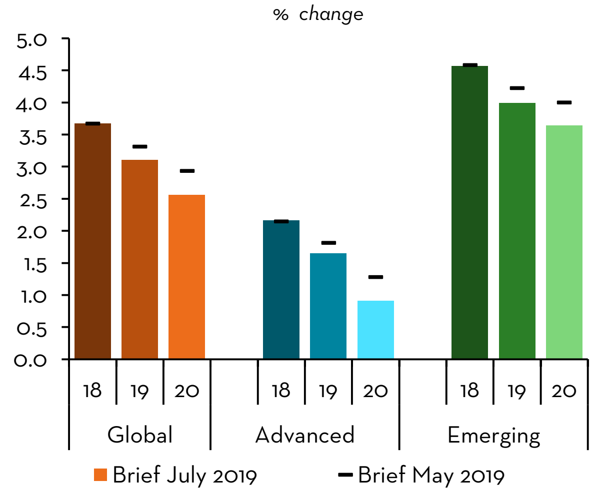
- The world economy is growing at slightly above 3% (Chart 1), but the outlook is becoming more uncertain: many threats loom and there are several shocks that could push the global economy to a less favourable equilibrium.
- Economic activity in China continues to slow down due to the trade tensions with the US, while policymakers are trying to revive the economy with fiscal and monetary measures.
- US growth remains robust and close to full employment. However, there are signs of a slowdown in the manufacturing sector and the trade tensions are starting to bite domestically.
- In the euro area, the business cycle weakness persists. Low foreign demand, Brexit, structural changes to the car sector (see InFocus) and pending threats of US tariffs are adding to the gloom.
- Monetary authorities in the main industrialized countries have reversed the normalization process, at least in the forward guidance declarations: with respect to the May Brief forecast, we are expecting the first Fed fund rate decrease after the summer and a more expansionary ECB policy.

Italy: second quarter, stagnation at best

- In 2019 Q1, GDP growth turned positive (+0.1% qoq) ending the technical recession of the second half of 2018, but remaining negative year-on-year (-0.1%, Chart 2). Domestic demand remained weak, due to the negative machinery and equipment investment and the fall in inventories, which highlights that uncertainty is weighing on firms' spending decisions.
- Our nowcasting models estimate growth to be at most zero in Q2, consistent with a further reduction in industrial production.
- We can confirm a modest recovery in the second half of the year, supported by resilient employment, low inflation and the slightly expansionary contribution provided by budgetary policy. GDP growth is projected to return to 0.5% yoy in Q4, 0.1% in the 2019 annual average.
- On 3 July, the European Commission concluded that an Excessive Deficit Procedure is no longer warranted for Italy. This decision is based on a better than expected budget outturn in 2019 and renewed commitments to a 2020 budget in line with the European rules.

Chart 1 – Real GDP

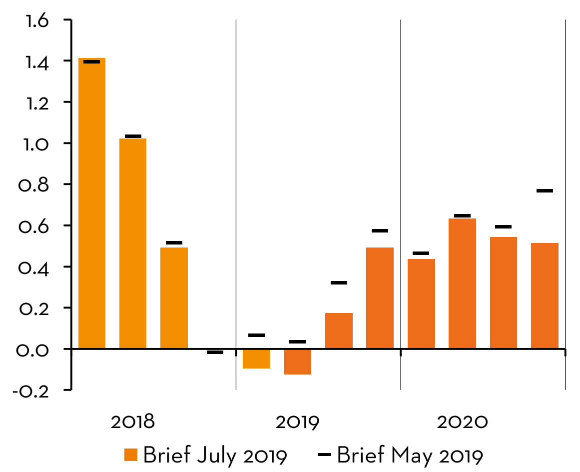
% change



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

Chart 2 – Italy: real GDP

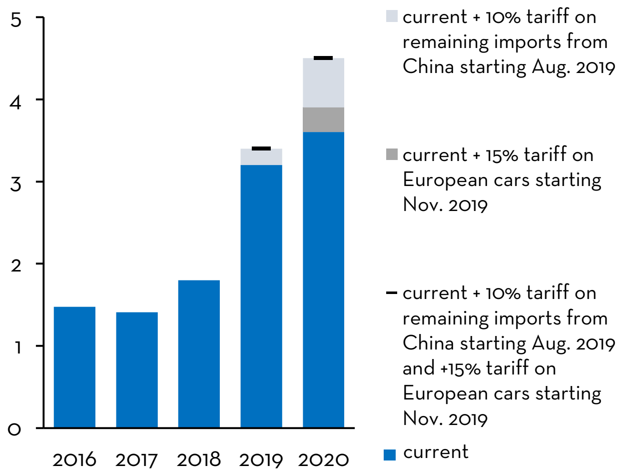
% change yoy



Source: Prometeia's forecast on Istat data.

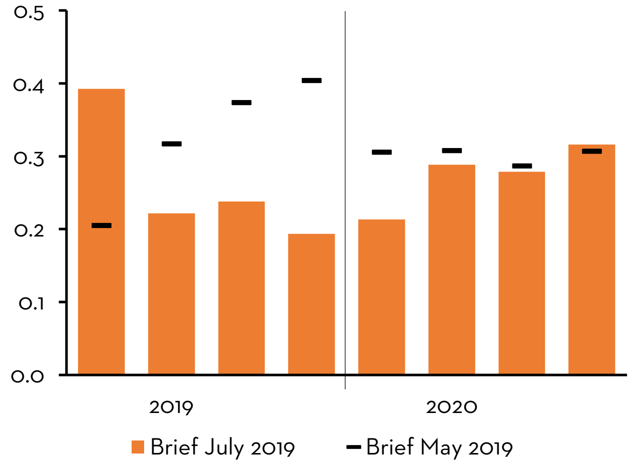
Global scenario

Chart 3 - US tariff rate under different scenarios -
as a % of total custom import values



Source: Prometeia's calculations on US Census Bureau data.

Chart 4 - Quarterly euro area real GDP
qoq% change



Source: Prometeia's forecast.

The current economic outlook is dominated by the US-China trade tensions. The recurrent ups and downs in the trade talks combined with a new wave of US duties (Chart 3) and retaliation from China is hindering global trade. A partially offsetting effect is being provided by the diversion of Chinese exports through other countries. The current worsening of US consumer and firm confidence is likely to weigh on investments and create concerns in the financial markets, inducing the Fed and the ECB to reassure the markets that they will adopt a more expansionary stance if necessary. We have revised global trade growth downward to 2.8% in 2019 and 2.4% in 2020, and revised global GDP to 3.1% and 2.6% respectively.

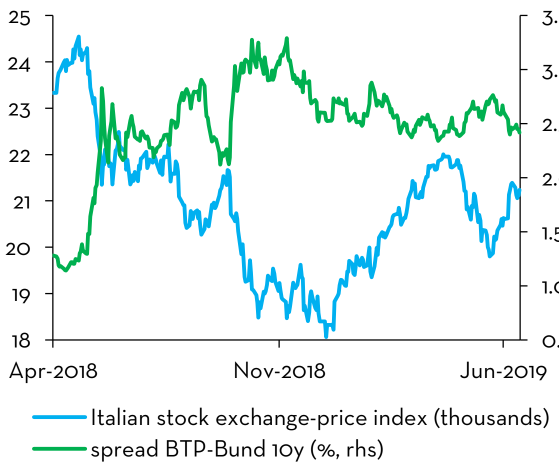
For the euro area, we forecast GDP growth of around 1% in both 2019 and 2020: this means no recession but a qoq GDP growth not above 0.2% for the rest of 2019 (Chart 4), a significant deceleration with respect to 2018. Many factors are contributing to this outlook, starting with the weakness in the German automotive sector which is undergoing a costly restructuring (see InFocus). The euro area is relatively more open to trade than other big countries, therefore the US and China decelerations, combined with the deceleration in global trade, are hitting the euro area particularly hard. Uncertainty continues to weigh on investment decisions, fed by many sources but, above all, Brexit and the threat posed by pending US duties on imported European cars. Given the subdued inflation rate, we expect the ECB to reduce the deposit facility rate by 10bp before starting TLTRO in September.

The US economy is suffering from trade tariffs, not only in terms of higher import-prices, but more especially in terms of manufacturing confidence, with some signs of slowing economic activity already appearing. The vigour of the labour market is reflected in higher wages, but no significant pass-through on the inflation rate which remains low and far from the monetary authority targets. This despite being sustained by higher tariffs on imported goods and by the high owner's equivalent rent stemming from the increased prices in the real estate market. We expect that because of the low inflation and weak expectations, the Fed will reduce interest rates in Q4 2019, earlier than in our May projections.

Trade and value chains are the main transmission channels of the global slowdown to EM. Moreover, the commodity prices are affected negatively by the expectations of slower global growth, adding further weakness to the commodity exporting EM. Softer monetary policies in most countries (and the reverse of US and euro area normalization process) and expansionary fiscal policy in some of them will provide some relief, supporting growth in the coming quarters. However, financial markets might amplify any arising problem (which could come from trade talks setbacks or specific country difficulties) increasing risk premia and financing constraints. For a few EM countries this has already put the national currency under pressure.

Italy

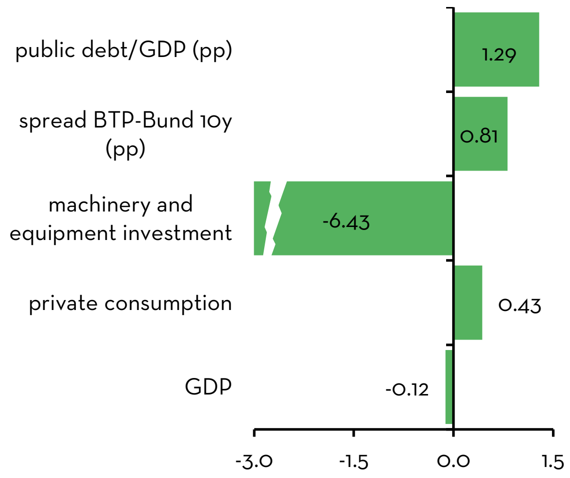
Chart 5 – Italian stock market index and spread BTP-Bund 10y



Source: Prometeia's calculations on Thomson Reuters data.

Chart 6 – A year of stagnation

differences between 2019 Q2 and 2018 Q2 (percentage and pp)



Source: Prometeia's calculations.

The technical recession is over... The first quarter of 2019 recorded GDP growth of 0.1% qoq, driven mainly by an increase in investment in construction and the sharp fall in imports due to lower demand for investment in machinery and equipment and reduced inventories. Exports have grown moderately and the contribution of net exports to GDP growth was positive.

...and Italian financial market conditions have been improving since the beginning of the year, ... Following the improvement in the global financial markets, the general Italian stock market index has regained most of the losses recorded in 2018 and the yield spread between Italian and German ten-year sovereign bonds is decreasing from its 2018 highs (Chart 5).

... but signs of vulnerability persist in 2019 Q2. Consumer and business confidence continued to decline in 2019 Q2, as did both the manufacturing (below 50 points) and services PMI.

The industrial sector was strongly affected by the weakening in world trade and by the difficulties in the automotive sector (see InFocus). The industrial production index fell in April, despite the substantial positive contribution of the energy sector. We expect a reduction in industrial production and stagnation of GDP in 2019 Q2. Based on this projection, the overall economic performance of the country during the last four quarters has been particularly weak (Chart 6).

Investment in capital goods is expected to increase in the second part of 2019, favoured by investment incentives (reintroduction of the "super-depreciation" in the so-called "Pro-growth decree" passed in April). The recovery of construction investment will continue, especially in the public sector, and it is expected to play an important role over the next two years.

Job creation accelerated in Q1 2019, but a slowdown is expected in the second half of 2019, when the Italian labour market will be influenced by the effects of the two measures characterizing the 2019 budget law, namely "Quota 100" and "Citizenship Income". In the latter case, an increase in participation rates can be expected, mainly in the South of Italy, as well as most likely an increase in the unemployment rate due to the increase in the number of people outside the labour force searching for jobs. At the same time, the exit from the labour market due to "Quota 100" will not be fully compensated by new hires. This should halt the increase in employment and the reduction in unemployment in the coming quarters.

Consumer inflation fell again to 0.9% in May 2019 (from 1.1% in April), driven mainly by falling oil prices, but also by lower prices of unprocessed food. Core inflation continues to be influenced by both cyclical and structural factors such as technological innovation and increased competition in the service sector. Over the coming quarters, inflation is expected to remain very low due to the oil price and to the expected appreciation of the euro against the dollar, which will reduce imported inflation, especially in 2020. These effects will ease the impact of the VAT increase included in the scenario, which we estimate will result in a price increase of 0.3%.

Loans to the private sector continue to expand slowly. In April, loans increased in Italy by 0.8% yoy compared to an increase in the EMU of 3.4%. This weak growth was attributable mainly to lending to non-financial corporations, which declined by 0.6% yoy, while the growth in loans to households remained fairly stable at 2.6% yoy. Consumer credit showed the most dynamic performance (9%) and mortgage loans also continued to expand (+1.6%). Qualitative surveys show some stability in credit conditions, following the tightening recorded in the previous months.

On 3 July, the European Commission decided not to propose "at this stage" a debt-based excessive deficit procedure which was warranted based on the first assessment of the 2019 Stability Programme. The Italian government has committed to respecting EU fiscal rules in both 2019 and 2020. In 2019, the fiscal correction adopted in the mid-year budget (improved revenue projections, smaller outlays on the new welfare policies and a new spending-freezing clause) reduced the estimated headline deficit by 0.4pp of GDP. The deficit/GDP ratio is now expected to reach 2.04%, meeting the target set (and approved by the Commission) in December 2018. In 2020, the Italian government gave assurances that the budget to be presented in the autumn of 2019 will improve the structural balance by ensuring full replacement of the VAT hike legislated. The Commission will monitor the execution of this package closely.

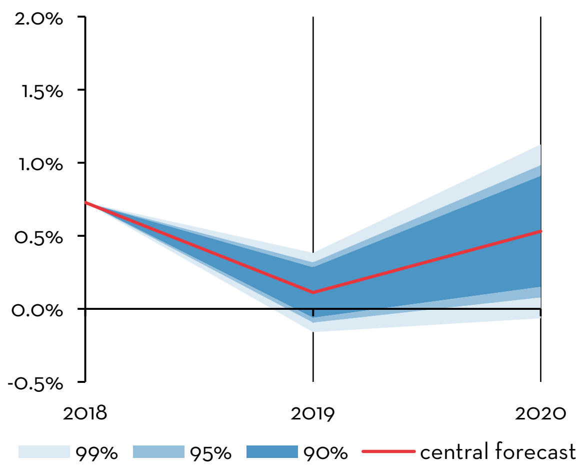
Tensions are expected to resume in the autumn, when the government will decide how to fund the repeal of the VAT hike (€23 billion) alongside the announced new measures envisaged by the government contract (such as further steps towards a new flat tax rate regime).

In our scenario, the funding of the 2020 budget will be only partial and the deficit/GDP ratio will increase from an actual 2.2% in 2019 to 2.5% in 2020. We include funding for about €9 billion from an increase in VAT reduced rates and from savings on the spending side. In addition, we expect a revision of tax expenditures worth about €8 billion, to finance new measures targeted at low-income households: a partial flat-tax and a strengthening of citizenship income. Under these assumptions, the budgetary measures are expected to have a moderately expansionary impact on GDP, of 0.1pp, in both 2019 and 2020.

Risks to the projection

- The ongoing trade talks between the US and China might not be successful and could trigger new tariffs hikes, which would negatively affect world trade and the Chinese economy even more. Threats of tariffs on the automotive sector in Europe could also materialize.
- The decline in Chinese domestic activity could accelerate notwithstanding the attempts of policymakers to stimulate the economy.
- Monetary policy easing in the US might be insufficient to tackle the ongoing slow-down in economic activity and, at the same time, could reduce the room of manoeuvre for the Fed in the case of a recession.
- The negative consequences of Brexit for Europe could prove to be more intense than expected due to the effect on value added chain linkages.
- The drafting of the Italian budget law for 2020 remains a source of risk to the stability of the ruling government, possibly triggering new tensions with the European Commission.

Chart 7 – Italy: Prometeia's forecast of annual GDP growth – *central projection and confidence levels*



Source: Prometeia's calculations.

The challenges for the European automotive sector: low demand, technological issues and demographic changes

The automotive sector was partly responsible for the slowdown in the euro area in 2018, particularly in Germany where it accounts for 20% of manufacturing value added (6%, 5% and 8% of value added in Italy, France and Spain respectively). During 2018, automotive sector activity was affected by numerous factors, some of which were temporary in nature, such as the new vehicle type-approval regulations and a natural decline in demand after years of expansion, while others were of a structural nature, such as the diffusion of electric/hybrid vehicles and car-sharing. In addition, the threat of US tariffs on cars could result in a redesign of the global automotive manufacturing structure.

In Germany, automotive production decreased by 9.8% between May and October 2018, before recovering by 3% in the following four months and then declining again. The automotive sectors in France and Spain declined by 6.8% and 7% respectively between 2017 and 2018, and then recovered. However, **in Italy, there was no reversal of the negative trend and a fall of 14% was recorded between December 2017 and April 2019** (Chart A).

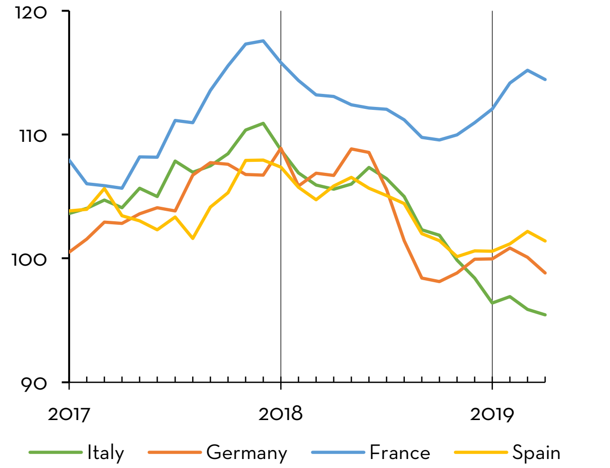
Moreover, **compliance with the European Union's emission limit of 95 g/km of CO2 before 2021 will induce an exponential increase in the supply of electric and hybrid vehicles**, which should represent 30%-40% of total new registrations in 2030. This should make it possible to reduce the wide gap with the American and Chinese markets.

European car manufacturers will have to make significant investments to convert from the internal combustion engine to electric cars, in a context of weak overall demand in the sector. In Europe electric cars are still marginal in total registrations, except in Norway where they have reached almost 50% of total registrations (Chart B). However, Italy has a share of only 0.5%.

In addition, **the ageing of the European population will lead in the medium and long term to a reduction in demand for cars**. With increasing age, car use reduces significantly and replacements are postponed. At the same time, young people are moving increasingly to alternative forms of car use, such as rental or shared use, in order to reduce the significant costs associated with car ownership.

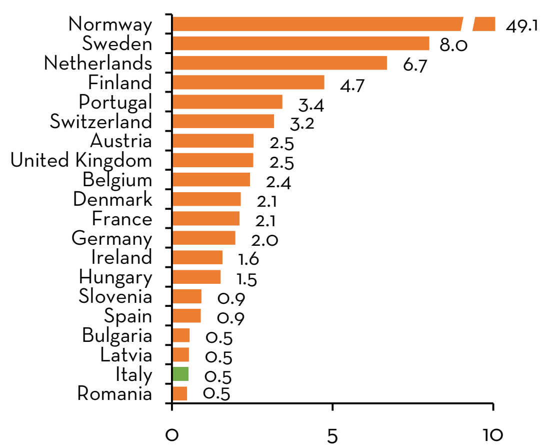
Chart A – Automotive manufacturing*

index 2015=100, moving averages 3 months on seasonally adjusted data



** Vehicles, components and accessories*
Source: Prometeia's calculations on Eurostat data.

Chart B – Share of electric cars* in total registrations in the main European countries in 2018 – %



**BEV (Battery Electric Vehicles) and PHEV (Plug-in Hybrid Electric Vehicles)*
Source: Prometeia's calculations on ACEA data.

Table 1 - The world economy: main indicators (% change)

	2018	2019	2020
World real GDP	3.7	3.1	2.6
World trade	3.3	2.8	2.4
Manufacturing prices $	5.1	1.2	4.8
Brent oil price ($/brl, level)	71.6	63.8	62.3
GDP			
- United States	2.9	2.3	0.9
- Japan	0.8	0.7	0.6
- EMU	1.9	1.1	1.0
- China	6.6	5.9	5.0
Consumer prices			
- United States	2.4	1.7	1.9
- Japan	0.9	1.2	1.5
- EMU	1.8	1.1	1.2
- China	2.3	2.8	2.3
$/€ exchange rate (level)	1.18	1.14	1.24
£/€ exchange rate (level)	0.885	0.886	1.005

Table 2 – Italy: main indicators (% change)

	2018	2019	2020
GDP*	0.7	0.1	0.5
Imports of goods fob and services	1.8	1.1	2.9
Private consumption	0.6	0.5	0.8
Government consumption	0.2	0.0	-0.1
Gross fixed investment:	3.2	0.6	1.5
- machinery, equipment, other products	3.9	-1.7	0.9
- constructions	2.2	3.5	2.2
Exports of goods and services	1.4	2.2	1.4
Domestic demand	0.9	-0.3	1.0
Industrial production	0.5	-0.3	1.0
Trade balance (% of GDP)	2.7	3.1	3.5
Terms of trade	-1.6	0.6	3.3
Consumer prices	1.1	0.5	0.9
Per capita wages - manufacturing	0.8	1.0	1.0
Total employment	0.8	0.5	0.1
General government balance (% of GDP)	-2.1	-2.2	-2.5

** Chain-linked values; data adjusted for seasonal and calendar effects.*

Table 3 - Exchange rates and interest rates

		19 Q1	19 Q2	19 Q3	19 Q4	20 Q1	20 Q2	20 Q3	20 Q4
Exchange rates vs euro	US dollar	1.14	1.12	1.13	1.18	1.23	1.24	1.24	1.24
	Yen	125.1	123.4	124.0	127.5	131.6	132.4	132.4	133.0
3 month interest rates %	US	2.70	2.53	2.44	2.28	2.02	2.00	2.00	2.00
	Euro area	-0.30	-0.30	-0.39	-0.40	-0.40	-0.40	-0.38	-0.25
10 year government bond yields %	US	2.64	2.34	2.06	2.04	2.02	2.00	2.00	2.00
	Germany	0.08	-0.14	-0.23	-0.12	-0.08	0.01	0.03	0.17
	Italy	2.71	2.43	2.31	2.51	2.31	2.31	2.27	2.36

Table 4 – Real GDP: comparison of the forecast – % qoq and annual % change – historical data in bold

		19 Q1	19 Q2	19 Q3	19 Q4	2019	20 Q1	20 Q2	20 Q3	20 Q4	2020
United States	Brief May 2019	**0.8**	0.5	0.5	0.2	2.5	0.1	0.3	0.6	0.5	1.3
	Brief July 2019	**0.8**	0.4	0.4	0.1	2.3	0.1	0.2	0.4	0.4	0.9
EMU	Brief May 2019	**0.4**	0.3	0.4	0.4	1.2	0.3	0.3	0.3	0.3	1.3
	Brief July 2019	**0.4**	0.2	0.2	0.2	1.1	0.2	0.3	0.3	0.3	1.0
Italy	Brief May 2019	**0.2**	0.0	0.2	0.1	0.2	0.1	0.2	0.1	0.3	0.6
	Brief July 2019	**0.1**	0.0	0.2	0.2	0.1	0.1	0.2	0.1	0.2	0.5

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based on data available up to 3rd July 2019

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