ITALY IN THE GLOBAL ECONOMY
PROMETEIA BRIEF

prometeia

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Executive summary

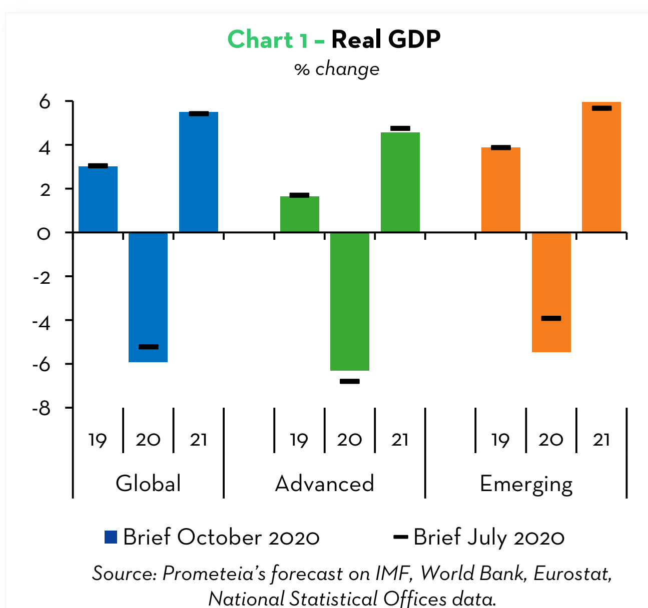
Global rebound in activity during the summer, but difficult to sustain

- After the collapse of global GDP during the summer and the suspensions of the restrictions put in place to reduce the diffusion of the coronavirus, economic activity rebounded, especially in the industrialized countries.
- Despite positive signs in the advanced economies, we are revising our global growth forecasts for 2020 downwards (Chart 1) because of the worsening situation in most of the emerging countries, from Latin America, to Asia, to India, where the Q2 GDP falls were much worse than expected and where the pandemic continues to have increasing effects.
- World trade is stabilizing, with positive increases posted in June and July, supported by the widespread recovery of industrial production in China, where it has nearly reached 2019 levels, and now extending to Europe and the US.
- Monetary and fiscal policies remain crucial to support incomes and activity worldwide. While the fiscal resources and monetary easing deployed in the industrialized countries are impressive, in many emerging countries no equivalent support is possible.

Italy: waiting for the European funds

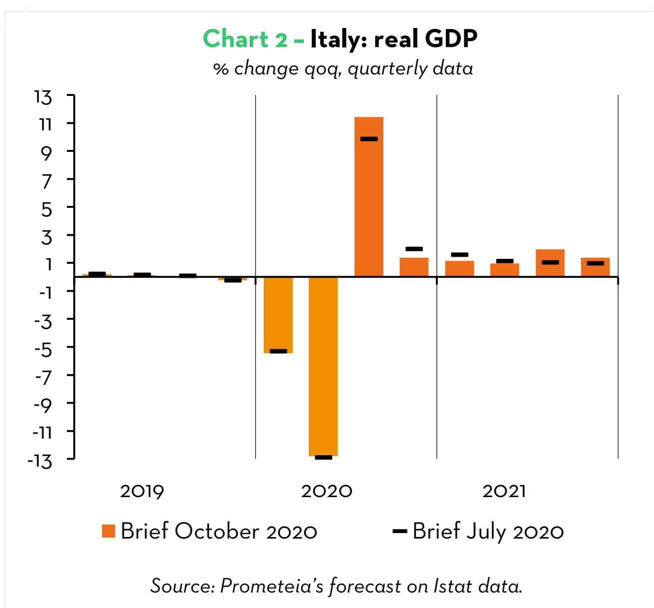
- Q2 data confirmed our forecasts for Italian growth: the lockdown resulted in a much higher fall than in Q1 (-12.8%), causing an unprecedented recession in the first half of the year (Chart 2). This is confirmed also by new quarterly data released on 2 October.
- The initial recovery shows a "V" shape. Despite having passed the lowest point in the crisis, the rebound will not be sufficient to overtake the losses suffered in the first part of 2020. GDP is expected to fall in 2020 by -9.6%.
- The expansionary impulse of budgetary policy has helped to contain the impact of the crisis in 2020 (by 4pp in our estimates) and will continue to support growth in 2021, although to a lesser extent. In addition to increased spending to sustain households and businesses, the Next Generation EU (NGEU) plans should contribute to the recovery (InFocus 1).
- The recently released government Update to the Economic and Financial Document (NADEF) indicates targets for 2021 in line with our scenario, envisaging a partial reduction of the deficit-to-GDP ratio (from 10.8% in 2020 to 7%, vs 10.9% and 6.4% in our scenario) and additional measures with a net expansionary effect of 1.3pp of GDP.

Chart 1 – Real GDP
% change



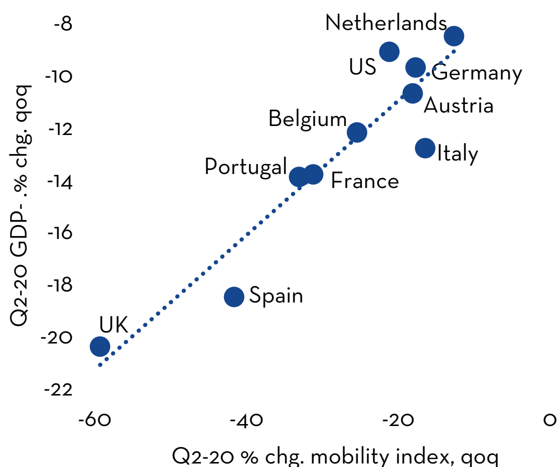
Source: Prometeia's forecast on IMF, World Bank, Eurostat, National Statistical Offices data.

Chart 2 – Italy: real GDP
% change qoq, quarterly data

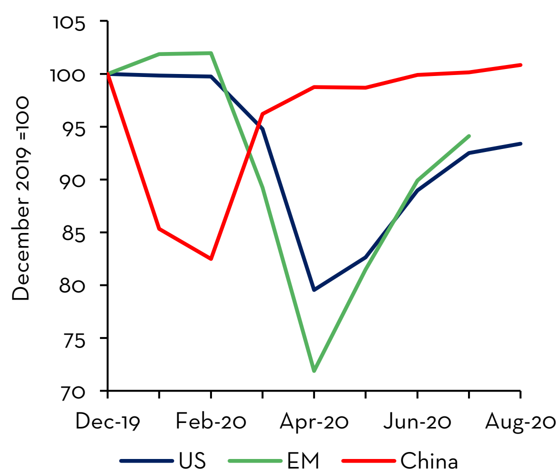


Source: Prometeia's forecast on Istat data.

Global scenario



Source: Prometeia calculations on national statistical offices and Google.



Source: Prometeia's calculations on National Statistical Offices data.

The collapse of GDP growth in the Q2-2020 was directly proportional to the intensity of the lockdowns (Chart 3). After the rapid fall in economic activity, many restrictive measures were relaxed triggering a growth rebound, which has been consolidating in recent months. However, the COVID-19 outbreak continues worldwide, with some countries showing signs of a second wave. This suggests that any recovery is fragile and might be less rapid than previously forecast.

Recovery of industrial production (Chart 4), especially in China, is the most important driver of the recent increase in commodity prices: the exception is the oil price which has shown lower than expected growth in demand, high stocks, and large supply due to the restarting of exploitation of the shale oil sector in the US and more relaxed OPEC cut policies.

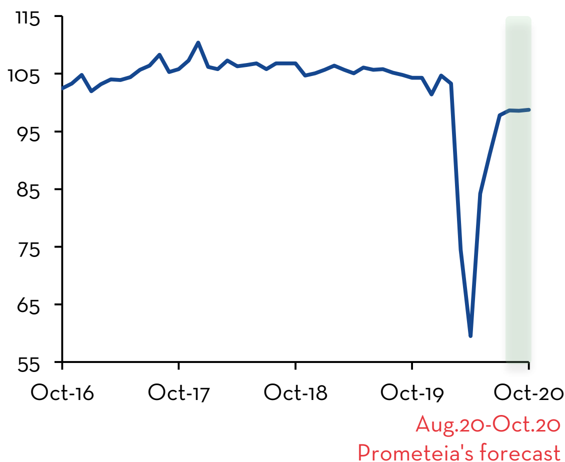
We expect euro area GDP to fall by 8% in 2020. Following the drop in GDP in Q2-2020 (-11.8% qoq, in line with our July forecast of -12%), the worst should be over, but recovery is proving slow. In the manufacturing sector, recovery in production and improvements to the economic indicators are providing a generally optimistic picture, but the service sector is suffering from both uncertainty over income and labor market trends and the restrictions at the local level to contain the risk of a second wave, especially in France and Spain, in the face of the recent increase in infections.

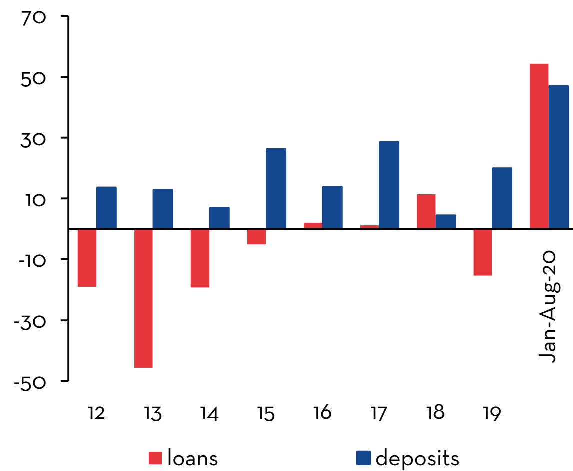
The EU is making great efforts to support the recovery. In 2021, Member States should be able to access significant amounts of European funds. We expect the first disbursement of NGEU funds by the end of 2021. Countries will receive also the funds available in the SURE programme (the European Council recently approved €87.3 billion for 16 Member States) and, finally, European Stability Mechanism (ESM) funding is available for those countries that request it. All these resources will contribute to EU GDP recovery (5.3% in 2021).

US monetary and fiscal stimuli to support incomes are larger than in any other crisis and have produced huge and beyond expectations support for demand, thanks also to households, which have reallocated part of their expenditure from sectors hit heavily by the COVID-19 pandemic (e.g., tourism and entertainment) to other categories (on-line purchases, domestic appliances, etc.). The ending of some unemployment benefit in the coming months and the still large and worrying increase in COVID-19 cases, are casting doubt on the resilience of demand going forward. The modification to the Fed's strategy, which has shifted the focus to average inflation and to shortfalls in full employment (rather than deviations from full employment), is paving the way to higher inflation in the future and a further delay in the next rate hike. In our scenario, we expect both the Fed and the European Central Bank (ECB) to maintain policy rates unchanged at least until 2023.

In China, after a strong rebound in the Q2 (11.5% qoq, 3.2% yoy), economic activity has continued to strengthen, led by the industrial sector. Services continue to lag, but are showing some positive signals. Construction is the main driver of investment (4.2% yoy in August), which continue to be weak but increasing in the manufacturing. Also retail sales grew in August (0.5% yoy) but cumulatively they are still 8.3% lower than in January-August 2019. Domestic demand has revived imports, while the worldwide recovery in production has favoured exports. Nevertheless, given the phasing out of fiscal support for incomes and employment, low profits and weak external demand, expectations about consumption and investment growths must be cautious.

Italy





Deep recession in Q2-2020: GDP – 12.8% qoq, -17.7% yoy. The fall in GDP in Q2 was due mainly to the negative contribution of domestic demand (-9.6pp), driven by the reduction in household consumption (-11.3% qoq and -17.3 yoy). Consumption of services fell by 24.1% yoy and even deeper falls were recorded for durable (-32%) and semi-durable (-25.3%) goods. Investments also registered a sharp decrease (-14.9% qoq) compared to Q1 (-7.9% qoq).

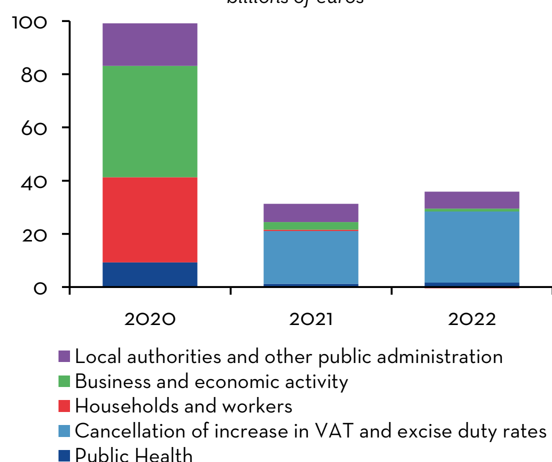
The recovery in the second half of the year should contain annual GDP at -9.6%. The recovery started in May and continued during the summer months. Industrial production, down 42.4% in April compared to February, grew by 16.2% between May and July. The recovery continued in Q3, at a slightly higher pace than expected, in both the industrial (Chart 5) and services sectors, triggered by domestic tourism over the summer which worked to partly offset the lack of foreign tourists. The strong increase expected in construction (from -19% in Q2 to +22% in Q3) should drive the recovery of total investment. We estimate a GDP rebound of 11.4% qoq in Q3 and growth of 1.4% qoq in Q4.

The labour market continues to deteriorate. Italy recorded a sharp decrease in the number of hours worked, measured as full-time equivalent units (over 4 million units less in Q2), while the drop in the number of employees (stronger for fixed-term contracts and the service sector) was less pronounced thanks to the social protection systems put in place. The latest data indicate a rise in the unemployment rate from the low of 8.5% in May to 9.7% in July, due to the simultaneous increase in the number of unemployed people and in the labour force. The gradual recovery of economic activity in the autumn is expected to lead to some 2 million additional hours worked, but only 50,000 employees by the end of the year.

Inflation is negative again. Consumer inflation fell further, to -0.5% in August and September. The upward trend in food prices, which in the spring offset the fall in oil prices, reversed in the summer months, contributing to a reduction in overall inflation. Core inflation also seems weaken, contributing to inflation forecast to be well below 2% in the coming years.

Financing to non-financial companies has increased. Loans to non-financial companies reached over €53 billion in the months to August (6% yoy according to ECB data), concentrated in long maturities. Loans were favoured by measures to support the liquidity of the economic system (moratorium on loans and guaranteed loans), and by ECB measures introduced in response to the COVID-19 emergency (TLTRO and PELTRO), which have provided banks with liquidity at rates lower than those of overnight deposits. Demand for guaranteed loans registered 1.14 million requests at end September for a total of €85 billion. This was mainly the result of precautionary measures, which provided an important buffer for liquidity in bank deposits (increased by €57 billion in the months up to August, Chart 6). This buffer is expected to be withdrawn in Q4 with the gradual improvement in economic activity and investments. We expect a significant acceleration in business loans this year (9.8% yoy), especially for longer maturities. Loans to households are also expected to grow in 2020 (1.3% yoy), as a result of increased consumption.

Chart 7 – The measures of the "Cura Italia", "Rilancio" and "Agosto" decrees: increase in deficit
billions of euros



Source: Prometeia elaborations on Parliamentary documents (DL 18/2020, 34/2020 and 104/2020).

The projected Non-Performing Loan (NPL) ratio has changed very little from our assessment in June. At the end of 2020, disposal of NPLs, estimated at around €24 billion, combined with the recovery of impaired loans will allow a 23.4% decrease in the NPL stock.

The fiscal deficit in 2020 will show an unprecedented deterioration. Between January and September, the state sector borrowing requirement rose to €128.2 billion, €73 billion more than the value in the same period in 2019 (€55 billion). In July, public debt exceeded €2,560 billion, up €150 billion from the end of 2019. In 2020, we expect the deficit-to-GDP ratio to rise to 10.9% (from 1.6% in 2019) and the debt-to-GDP ratio to rise by almost 23pp, to 158.1%.

The fiscal response to the crisis in 2020 amounted to €100 billion (6% of GDP) based on official assessments. Between March and August, the Italian government published three decree-laws (Cura Italia, Rilancio and Agosto), which introduced a number of expansionary measures, aimed mainly at providing economic support to workers and firms. Most of these measures are temporary and are expected to reduce considerably in each of the two years 2021 and 2022, when the largest part of the increasing effects of the deficit is related to the cancellation of the previously-legislated VAT and excise duty rate increases (Chart 7).

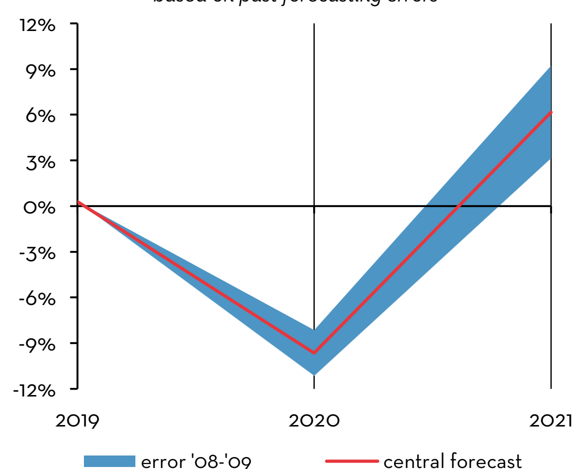
In our scenario, and consistently with the NADEF, in 2021 budgetary policy will continue to be supportive to the economy. The measures approved in 2020 together with those envisaged in our scenario for 2021 are estimated to be about 2.5pp of GDP, of which 0.8pp is additional spending financed through NGEU funds (InFocus 1).

GDP growth of 6.2% in 2021. In 2021, private and public investments will grow at 10.5%, favored by both the recovery of the economic cycle and the NGEU funds (whose effect should begin to appear in the second half of 2021). The rebound in consumption will be modest (5.7%) due to the persistence of uncertainty in both economic and health terms. As a result, the fall in the propensity to consume in 2020 (from 92.3% to 85.2%), due to the lockdown and precautionary savings, will be only partially reabsorbed in 2021. At the end of 2021, GDP will still be 1.7% lower than at the end of 2019.

Risks to the projection

- Widespread COVID-19 outbreaks could derail/postpone the recovery.
- In the medium term, rising global public and private debts could hold back average growth.
- In the US, a prolonged chaos following the November presidential election could increase uncertainty and postpone policies aimed at supporting growth.
- Political and trade conflicts between the US and China and a disorderly Brexit (without trade agreements with the EU) could further limit and fragment global trade and dent GDP growth.
- Political and administrative issues could delay implementation of the European support programmes (especially the NGEU) slowing the expected recovery and increasing uncertainty.

Chart 8 – Italy: Prometeia's forecast of annual GDP growth – *central value and uncertainty based on past forecasting errors*



Source: Prometeia's calculations.

Prometeia's assessment of how Next Generation EU funds will be used

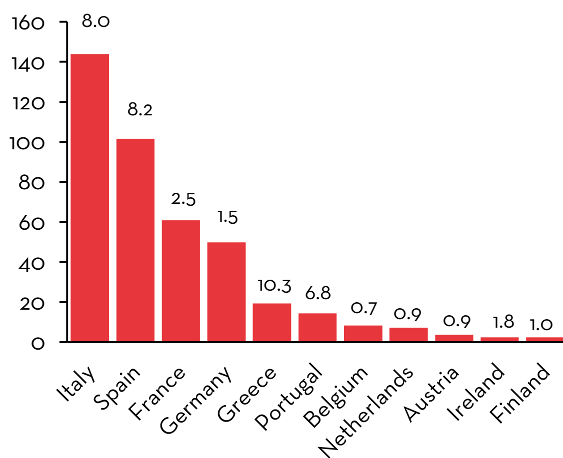
Following the European Council's decision in July, implementation of the recovery support programmes - launched by the European institutions in response to the current crisis - is underway.[1]

The resources made available by the three pillars of the Next Generation EU (NGEU)[2] have been confirmed to be worth €750 billion, split between grants and loans (respectively €390 billion and €360 billion compared to the Commission's original proposal of €500 billion for grants and €250 billion for loans).

The ad hoc pandemic emergency programme, the Recovery and Resilience Facility, is worth 90% of total resources (€672.5 billion). It aims "to help repair the immediate economic and social damage brought about by the coronavirus pandemic, support an economic recovery and build a better future for the next generation". To access this, Member States must submit detailed reform and investment programmes (National Recovery and Resilience Plans), according to the guidelines published by the Commission on 17 September,[3] which require consistency between reforms and investments, in line with EU policy priorities and recommendations for each country, estimation of the impact with respect to the relevant variables, precise and verifiable timings and intermediate targets. The green and digital transitions will be decisive for a positive assessment of the plans by the Commission: a minimum of respectively 37% and 20% of the expenditure must be devoted to these aspects. In addition, the projects must follow the principle of "do no harm" and must demonstrate pursuit of social cohesion, reduction of inequalities and strengthening of the resilience of social and economic systems.

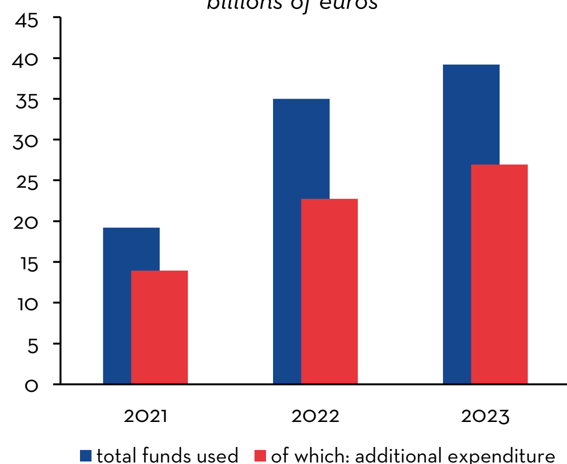
The deadline for submission of the National Recovery and Resilience Plans is 30 April 2021, with the invitation to submit a first draft on 15 October 2020, together with the Draft Budgetary Plans, to allow discussion with the Commission to begin, which should enable the definition of viable and acceptable programmes.

Chart A – Next Generation EU - assumptions 2021-2027
*billions of euros **



** as % of GDP 2019 in the numbers at the top of the bars*
Source: Prometeia's forecasts on European Commission data.

Chart B – Italy: expenditure financed by NGEU funds in the period 2021-2023
billions of euros



Source: Prometeia's forecasts on European Commission data.

1 *Prometeia Discussion Note n. 14, "Italy: post COVD-19 recovery: will this time be different?"*
2 *Pillar 1: Supporting Member States to recover, Pillar 2: Kick-starting the economy and helping private investment, Pillar 3: Learning the lessons from the crisis.*
3 *https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/recovery-plan-europe/pillars-next-generation-eu_en.*

The National Recovery and Resilience Plans discussions will guide the planning of budgetary policies in the coming months and, in this sense, the commitment seems significant (the Italian government submitted the guidelines to Parliament on 9 September).

Therefore, **although we have no firm information, we provide a scenario of how the plans might be implemented.** We estimate that not all potential resources will be spent. Difficulties related to planning and implementation, opportunities and accessibility (willingness to exploit loans will increase with the increased sovereign bond spread), in our scenario, could lead to an ex-post realization of the programmes, representing around 70% of the possible 100%. Chart A shows the expected access to funds for the 11 main EMU countries in the years 2021-2027.

Taking account of both the criteria for the cross-country allocation of resources and the funding conditions, **Italy will be the largest beneficiary in absolute value**: €145 billion according to our assessment, split across €70 billion in grants and €75 billion in loans. In terms of GDP, the amount of resources is similar to that of Spain (8.2%), which we estimate will use about €100 billion, but lower than that of Greece, where the cumulative resources could exceed 10% of GDP.

Under our assumptions, in Italy, the timing of the expenditure related to NGEU funding **includes a cumulative total of about €93 billion in the 2021-2023 period, allocated to direct public investment and to the financing of private sector investment**, as indicated by the Commission, which identifies closing of investment gaps as the main objective. However, not all of these resources will be additional expenses compared to a scenario without access to NGEU funds. In line with the Ministry of Economy and Finance statement, the expenses related to grants will be entirely additional, while the loans component will go to financing expenses, which, in part, would have been implemented in any case (e.g., funds already allocated to the new green deal and innovation). Overall, we assume availability of additional expenditure up to approximately 69% of the total funds used, corresponding to additional public spending of 1.2% of GDP per year on average. Since access to the funds is expected to start in the second half of next year, the additional expenditure should amount to about 0.8pp in 2021 (€14 billion) and should reach 1.5% in 2023 (Chart B). The Italian government is planning to allocate a similar amount (€25 billion in 2021, of which around €14 billion of additional grants) in its Update to the Economic and Financial Document policy scenario just released.

Given the allocation of expenditure to investment, the impact on growth will increase even beyond what the historical multipliers would suggest. Based on historical data, our models estimate a public expenditure multiplier below 1. However, given the current context, which includes a negative output gap and supportive monetary policies, we estimate that the multiplier could be above 1.[4] Therefore, the contribution to GDP of the additional expenditure under the NGEU is estimated **at about 1.3pp of GDP per year, on average, between 2021 and 2023.**

In the case of the **EMU** as a whole, we assume that, **at the end of 2023**, there will be about **€370 billion of actual investments** financed by EU funds, of which **over €200 billion will be additional** money (enabled only by the availability of EU funds). This will allow **GDP in the euro area** between 2021 and 2023 **to be about 0.8pp higher** than without the NGEU resources.

4 *A value in line with that reported in Busetti, F. C. Giorgiantonio, G. Ivaldi, S. Mocetti, A. Notarpietro e P. Tommasino, Capitale e investimenti pubblici in Italia: effetti macroeconomici, misurazione e debolezze regolamentari, Questioni di Economia e Finanza (Occasional Papers) n. 520, Banca d'Italia, ottobre 2019.*

Euro strength and EMU inflation

Since December 2019, the euro has strengthened by around 7% against the dollar and 8.3% in nominal effective terms (Chart A), contributing to the reduction of inflation and providing a further distance from the ECB's target.

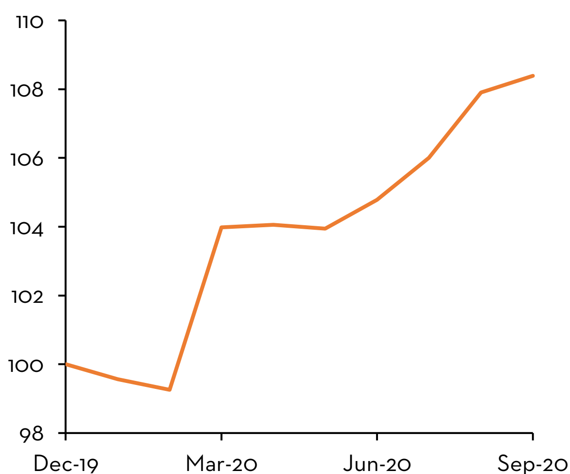
Changes to the exchange rate affect economic activity and inflation by modifying price competition. In the case that the euro appreciates, the competitiveness of euro area goods with external countries will deteriorate, which will have a depressive effect on exports and an expansionary effect on imports. The extent to which this will happen will depend on numerous macro and micro economic elements, including the market power of companies, the price elasticity of demand and the economic cycle.

There are also second round effects affecting domestic demand in response to exchange rate changes. The demand for investment goods will decrease, given the greater propensity of exporting companies - the most penalized in this context - to invest. The demand for consumer goods will be favored, initially, by the increased purchasing power due to the reduction in consumer prices. The fall in import prices in the national currency will translate into lower costs for companies, which, if passed through, will imply lower prices for consumers. If operators incorporate the fall in prices in their expectations, then in subsequent years, both price levels and inflation will change, with significant consequences for the conduct of monetary policy.

Simulation exercises with Prometeia's models, which take account of all these relationships, allow us to quantify the effects of a euro appreciation on GDP growth and inflation. We have assumed a nominal effective euro appreciation of 10%. For individual countries this will translate into a lower appreciation between 5% and 6%, given the significant weight of intra-area trade which is not subject to the direct effects of exchange rate fluctuations. As expected, this will have a depressive effect on GDP, which after one year will be 0.5pp lower in the euro area and 0.4pp in Italy, while consumer prices will reduce by about 0.7pp (Chart B).

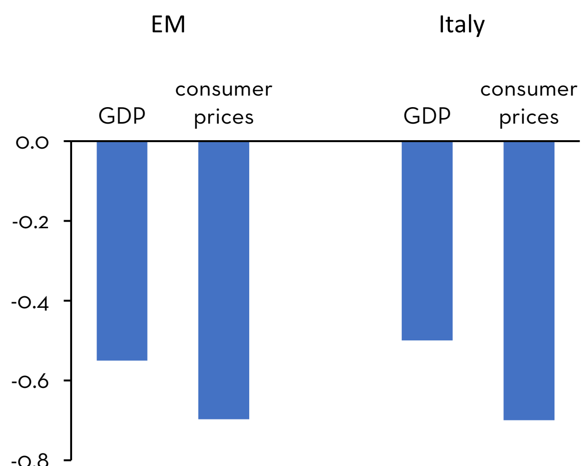
These results suggest that the euro appreciation observed so far could reduce inflation in the EMU and in Italy by about 3-4 tenths of a percentage point in 2020 and should not completely exhaust the disinflationary effects within a year. In particular, euro area inflation in 2020 could be 0.6% instead of the expected 0.3%, and inflation in Italy could be 0.2% instead of -0.1%.

Chart A – Euro nominal effective exchange rate
December 2019=100



Source: Prometeia calculations on Refinitiv e IMF data.

Chart B – Stronger euro effects on GDP and consumer prices
% deviation from baseline after 1 year



Source: Prometeia.

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

	2019	2020	2021
World real GDP	3.0	-5.9	5.5
World Trade	-0.5	-13.4	10.4
Manufacturing prices $	-2.6	0.1	1.1
Brent oil price ($/brl, level)	64.2	43.2	44.8
GDP			
- United States	2.2	-4.2	3.9
- Japan	0.7	-7.3	4.3
- EMU	1.3	-8.0	5.3
- China	6.1	1.6	8.8
Consumer prices			
- United States	1.8	1.1	1.6
- Japan	0.5	1.4	0.3
- EMU	1.2	0.3	1.1
- China	4.0	4.6	2.3
$/€ exchange rate (level)	1.12	1.14	1.13
£/€ exchange rate (level)	0.877	0.889	0.904

Table 2 – Italy: main indicators (% change)

	2019	2020	2021
GDP*	0.3	-9.6	6.2
Imports of goods fob and services	-0.2	-14.0	15.1
Private consumption	0.4	-10.6	5.7
Government consumption	-0.4	0.2	2.6
Gross fixed investment:	1.4	-12.7	10.5
- machinery, equipment, other products	0.4	-14.2	7.9
- constructions	2.6	-10.8	13.5
Exports of goods fob and services	1.4	-16.9	15.4
Domestic demand	-0.2	-8.6	6.0
Industrial production	-1.1	-11.8	12.9
Trade balance (% of GDP)	3.2	3.7	3.4
Terms of trade	1.5	4.7	-0.8
Consumer prices	0.6	-0.1	0.7
Per capita wages - manufacturing	1.9	0.0	0.7
Total employment	0.3	-10.0	4.9
General government balance (% of GDP)	-1.6	-10.9	-6.4

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

Table 3 - Exchange Rates and Interest Rates

		20 Q1	20 Q2	20 Q3	20 Q4	21 Q1	21 Q2	21 Q3	21 Q4
Exchange rates vs euro	US dollar	1.10	1.10	1.17	1.20	1.16	1.13	1.12	1.13
	Yen	120.1	118.3	124.8	127.5	123.6	120.9	120.6	121.5
3 month interest rates %	US libor	1.51	0.58	0.26	0.25	0.25	0.25	0.26	0.27
	Euribor	-0.37	-0.30	-0.45	-0.47	-0.47	-0.47	-0.47	-0.47
10 year government bond yields %	US	1.39	0.69	0.65	0.69	0.71	0.72	0.77	0.81
	Germany	-0.44	-0.47	-0.51	-0.51	-0.50	-0.49	-0.47	-0.47
	Italy	1.25	1.64	1.03	1.07	1.06	1.12	1.12	1.12

Table 4 – Real GDP: comparison of the forecast – % qoq and annual % change (historical data at 1 October in bold)

		20 Q1	20 Q2	20 Q3	20 Q4	2020	21 Q1	21 Q2	21 Q3	21 Q4	2021
United States	Brief July 2020	**-1.3**	-13.1	8.1	4.7	-5.7	0.2	0.4	0.3	0.3	4.4
	Brief October 2020	**-1.3**	**-9.1**	5.9	1.6	-4.2	1.1	0.8	0.8	0.7	3.9
EMU	Brief July 2020	**-3.6**	-12.0	7.6	3.1	-8.1	0.5	1.1	1.3	1.1	5.0
	Brief October 2020	**-3.7**	**-11.8**	8.6	1.6	-8.0	1.1	1.2	1.6	1.4	5.3
Italy	Brief July 2020	**-5.3**	-12.9	9.8	2.0	-10.1	1.6	1.1	1.0	1.0	5.9
	Brief October 2020	**-5.5**	**-12.8**	11.4	1.4	-9.6	1.2	1.0	2.0	1.4	6.2

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based on data available up to 1st October 2020

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